FEDERAL TRANSFER PAYMENTS AND NEW BRUNSWICK'S PUBLIC FINANCES

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FORWARD

This report has been prepared by the New Brunswick Department of Finance. The report is based on work and analysis undertaken by the Department in conjunction with its participation in the recent round of negotiations with respect to federal-provincial fiscal arrangements.

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CHAPTER I
INTRODUCTION

The Parliament of Canada recently amended the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977. This legislation, which is often referred to as the "fiscal arrangements" or the "Fiscal Arrangements Act", provides for several key programs and agreements in federal-provincial fiscal relations. These are:

1) Federal Transfer Payments to Provinces:

   a) Equalization grants;
   b) Established Programs Financing (EPF) grants for health care and post-secondary education; and
   c) Extended Health Care grants (usually included with EPF).

2) Federal-Provincial Agreements:

   a) Income Tax Collection Agreements covering personal and corporate income taxes;
   b) Reciprocal Taxation Agreements which provide terms by which federal and provincial governments pay each others' consumption taxes.

3) Fiscal Stabilization by which the federal government provides financial support when provinces experience a year-over-year decline in revenues;

4) Revenue Guarantee by which the federal government pays provinces cash grants if federal income tax changes result in a one percent or greater decline in federal basic tax;

By far the most important elements of fiscal arrangements to New Brunswick are equalization and EPF payments.

The purpose of this paper is to report on the changes to the fiscal arrangements which have now been made by Parliament, and which will affect the level of transfer payments to the provinces for the next five years. In addition this report provides an analysis of the operation of the federal-provincial transfer system in the recent past, and it provides a synopsis of the latest round of negotiations with respect to that system, including New Brunswick's role in those discussions. The report concludes with an overview of the impact of recent changes in Fiscal Arrangements on New Brunswick.

Chapter II of this report outlines the background to the present day system of fiscal arrangements in Canada and summarizes the major changes in fiscal arrangements in the years ahead. Chapter III gives an overview of the effect federal restraint has had on New Brunswick's financial position in recent years. Chapter IV outlines the impact on New Brunswick of changes in federal funding for health care and post-secondary education. Chapter V gives a theoretical explanation of the rationale for fiscal equalization and a

brief review of equalization in Canada. It also provides an analysis of deficiencies in the federal equalization program and what these have meant to New Brunswick. Chapter VI provides an overview of the latest round of negotiations concerning the equalization program, and New Brunswick's role and position on the issues that were discussed with the federal government. Chapter VII outlines the 1987 fiscal arrangements, and summarizes what these arrangements mean to New Brunswick.

CHAPTER II
BACKGROUND TO THE CURRENT SYSTEM OF FISCAL ARRANGEMENTS AND SIGNIFICANCE TO NEW BRUNSWICK

General

Under the British North America Act the provinces were left with responsibility for health, education and welfare. Because expenditures on these services were not expected to grow significantly, provinces' revenue raising powers were limited to direct taxation. The federal government on the other hand, was given unlimited powers of taxation.

Provincial sources of revenues soon proved inadequate to meet provincial responsibilities. Consequently, federal grants were introduced shortly after Confederation to help the provinces meet their expenditure obligations.

This practice has continued since Confederation, although the type of grants paid, the formulae for determining federal payments to the provinces, and the purpose of such payments has changed at frequent intervals over the past 120 years to meet the evolving needs of Canadian federalism.

The Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977, is the cornerstone of present fiscal arrangements between the two senior levels of government in Canada. Traditionally, federal-provincial fiscal arrangements are negotiated at five year intervals. Federal-provincial negotiations covering fiscal arrangements for the period April 1, 1987 to March 31, 1992 have recently been completed. Bill C-44, which contained

the most recent changes to fiscal arrangements was given Royal Assent on April 14, 1987. This legislation extended the current equalization formula for the next five years and provided for a number of technical changes to the formula. Bill C-96 which altered the EPF program, received Royal Assent in June, 1986. These changes together with the provisions of the fiscal arrangements legislation which remain intact, define the terms by which the major federal transfer payments are to be made to provincial governments for the next five years.*

Financial Significance of Federal-Provincial Fiscal Arrangements

Equalization, Established Programs Financing, and the Tax Collection Agreement are the most important programs authorized by the Fiscal Arrangements Act. Table 2.1 illustrates the significance of these sources of revenue to the Province of New Brunswick.

TABLE 2.1

REVENUE RECEIVED VIA FISCAL ARRANGEMENTS ACT:

RELATIVE CONTRIBUTION TO NEW BRUNSWICK'S

GROSS ORDINARY REVENUE

1986-87

	Percent
Equalization	23.0
Established Programs Financing[1]	10.5
Tax Collection Agreement	18.0

[1]Includes extended health care.

*See Appendix 1 for a summary of the equalization formula for the period 1987 to 1992, and Appendix 2 for a summary of the EPF formula now in place.

This table shows that in 1986-87 for example, the two major transfer programs (equalization and EPF) provided 33.5 percent of the Province's gross ordinary revenue. Equalization is the single largest revenue source of the Province and, together with EPF was budgeted to contribute $944 million to New Brunswick's revenues in 1986-87. This is more than was budgeted for personal and corporate income taxes, diesel and gasoline taxes, property tax and the tobacco tax combined.

Because equalization and EPF play such an important role in New Brunswick's financial picture, any change in either of these programs is significant. The latest round of negotiations and the outcome of those discussions is particularly important for the Province, which has been struggling with a persistent deficit since 1982-83.

Background to The Latest Round of Negotiations

While fiscal arrangements legislation is enacted by the Parliament of Canada, historically the federal government has sought provincial concurrence before amendments to this legislation were placed before Parliament. Since 1957, the provinces and the federal government have met every five years to review the fiscal arrangements. These reviews have involved joint analysis and examination of the state of federal and provincial finances and responsibilities.

In the past, federal and provincial governments would jointly evaluate the arrangements of the previous five years, identify problems and attempt to reach a considerable measure of agreement on the arrangements for the next five year period. There is, however, no signed agreement on this between the two levels of government, and the federal government is ultimately responsible for the content and administration of the legislation pertaining to fiscal arrangements in Canada.

The latest round of negotiations began in the Autumn of 1985 following the federal Budget in May of that year. Over the course of the next year and a half there were a number of technical meetings among federal and provincial officials, seven federal-provincial Finance Ministers' meetings, two meetings of provincial Finance Ministers and a meeting of First Ministers where this subject was discussed. During these meetings the provinces drew attention to certain fundamental shortcomings of the federal transfer system that had been in place since 1982. Several provinces, including New Brunswick, suggested improvements to the equalization program, and EPF.

Shortly after the 1982 fiscal arrangements were put in place it became obvious that New Brunswick and a number of other provinces would face serious financial difficulties due to the combined effect of the recession that began in 1982, and the federal transfer system that was established for the 1982 to 1987 period. New Brunswick was forced to respond to these financial difficulties with a multi-year expenditure restraint program, and significantly increased taxes. Despite these actions the provincial deficit remained a large and challenging problem. Consequently, even before formal discussions began concerning the fiscal arrangements for the 1987 to 1992 period, New Brunswick had recognized its deficit problem and was pressing the federal government for improvements to the federal transfer system. The Province contended that increased federal transfer payments were essential if it was to get back to a healthy financial situation.

Against this backdrop, the fiscal arrangements package which has now been put in place, and which will form the basis of equalization payments and federal grants for health care and post-secondary education for the next four years, can at best

only be considered a partial improvement over the system which had been in place during the preceding five years. While the equalization program has been improved, and New Brunswick will be the greatest beneficiary of the improvements to that program, equalization payments will still not be sufficient to enable the Province to provide "comparable levels of service at comparable levels of taxation". Furthermore, when the improvements to the equalization program are put in context with the changes in the EPF formula which reduced the rate of growth in those payments, it remains very clear that much remains to be done to eliminate fiscal disparities in Canada.

CHAPTER III
RECENT TRENDS IN FEDERAL TRANSFER PAYMENTS AND IMPLICATIONS FOR NEW BRUNSWICK'S FINANCES

New Brunswick has held the view that its fiscal difficulties since 1982 have stemmed in part from shortfalls in transfer payments (transfers) from the federal government. The Province has further believed that these shortfalls were the result of inadequacies in the equalization and EPF formulae. This Chapter together with Chapters IV and V, outlines the arguments that New Brunswick has advanced to the federal government in this regard.

Trends in Federal Transfers and Provincial Expenditures

Transfers from Canada have traditionally played a significant role in enabling the Government of New Brunswick to meet its expenditure obligations. Federal transfer payments have enabled New Brunswick to provide its citizens with public services, which it otherwise could not afford. The following table makes this clear.

TABLE 3.1

FEDERAL TRANSFERS AS A PERCENT OF

NEW BRUNSWICK'S ORDINARY EXPENDITURES

FOR THE FISCAL YEAR ENDING MARCH 31, 1973 TO 1982[1]

	Equalization	All Federal Transfers
1972-73	22	45
1973-74	26	48
1974-75	25	49
1975-76	23	48
1976-77	21	46
1977-78	24	46
1978-79	26	49
1979-80	29	52
1980-81	22	44
1981-82	24	44

[1]The period in Table 3.1 coincides with 2 major reviews of federal-provincial fiscal arrangements. During this period EPF was introduced to replace cost sharing arrangements for medicare, hospital services and post-secondary education. In addition, there were two quinquennial reviews of the equalization program, both of which resulted in major changes to the formula.

Over the period 1972-73 to 1981-82 the federal equalization program was consistent in financing about 24% of ordinary account spending by the New Brunswick Government despite numerous changes in the equalization formula in the seventies.* Over the same period, federal transfers as a whole covered about 47% of New Brunswick's ordinary expenditures, even with the move to EPF in place of separate cost sharing arrangements for health care and post-secondary education.

There were years when the level of federal support varied, but these can be explained by prior year adjustments and the phasing in features of EPF which meant a more rapid increase in federal payments in 1978-79 and 1979-80. In spite of year to year variation, federal support for provincial spending remained close to the average of 47% for the period 1972-73 to 1981-82, and in no year did it fall below 44%. This trend ended in 1982-83 and since that year there has been a decline in federal transfers as a percent of New Brunswick spending. This is shown in the following table.

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*These changes included the addition of school purposes taxes, the 50% ceiling on non-renewable resource revenues, the one-third cap on resource related equalization, the removal of Crown oil and gas land sales from the program and the ineligibility provision for provinces with above average personal income.

TABLE 3.2
FEDERAL TRANSFERS AS A PERCENT OF
NEW BRUNSWICK'S ORDINARY EXPENDITURES
FOR THE FISCAL YEARS ENDING MARCH 31
1983 TO 1987

	Equalization	All Federal Transfers
1973-82 Average	24.0	47.0
1982-83	25.5	41.9
1983-84	22.0	41.1
1984-85	21.2	39.7
1985-86	23.8	41.4
1986-87	22.9	41.0

Table 3.2 shows that for the period 1982-83 to 1986-87, there has been a substantial reduction in federal transfers in relation to ordinary expenditures of the New Brunswick Government. As noted above, from 1972-73 to 1981-82 federal transfers covered about 47% of New Brunswick's ordinary expenditures. From 1982-83 to 1986-87 this level of support fell to 41%. It is projected to continue on this lower trend in the coming years.

Implications of Reductions in Federal Financial Support

The consequences of this decline in federal support for New Brunswick's expenditures have manifested themselves in a number of ways. Since 1981-82, the Province has raised taxes significantly, restrained spending and continued to incur an ordinary account deficit. New Brunswick would not have had to deal with such a difficult financial situation if federal transfers over the past five years had remained on the same trend as during the 1972-73 to 1981-82 period. The following table demonstrates this.

TABLE 3.3

ORDINARY ACCOUNT SURPLUS (DEFICIT) ASSUMING FEDERAL TRANSFERS MADE THE SAME CONTRIBUTION TO THE PROVINCE'S ORDINARY ACCOUNT SPENDING IN THE 1980'S AS THEY DID IN THE 1970'S

($Millions)

Fiscal Year	Ordinary Surplus (Deficit)	Increase in Federal Transfers if Historical Share of Spending Had Been Maintained	Revised Surplus (Deficit)
1982-83	(202.8)	110.3	(92.5)
1983-84	(131.5)	139.2	7.7
1984-85	(133.8)	181.9	48.1
1985-86	(48.7)	146.7	98.0
1986-87[1]	(46.8)	171.2	124.4

[1]Third Quarter

The first column in Table 3.3 above shows New Brunswick's ordinary account deficit since 1982-83. The second column gives the amount of additional federal funding that would have been received if federal transfers had covered the same percentage of ordinary spending since 1982-83 as they did in the decade before 1982-83. The third column shows what the deficit would have been with this additional federal revenue. Under these circumstances, the Province's deficit would have been reduced to $92.5 million in 1982-83, from the actual deficit of $202.8 million, and the Province would have had significant ordinary account surpluses each year since 1983-84. Alternatively, the Province would not have had to restrain spending or raise taxes as much as it did.

There are three possible explanations for the change in federal funding trends. These are: (1) provincial expenditure growth, (2) EPF contraction, and (3) the behaviour of equalization payments. Concerning expenditures, consolidated provincial/local per capita spending in New Brunswick has been among the lowest in Canada for at least the past decade and a half. This is shown in Appendix 3. Furthermore, the spending gap between New Brunswick and the country as a whole as represented by the Canadian average, has not narrowed significantly in recent years, and public spending in New Brunswick remains among the lowest in the country. No case can be made that New Brunswick's deficits in the past five years arose from a level of spending that was excessive in comparison to other provinces.*

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*The term "provincial local" refers to the consolidated accounts of the provincial local components of the public sector. It is useful to focus on the consolidated provincial local sector when making interprovincial comparisons. By doing this, problems that arise when comparing provinces with different types of provincial local government structures can be avoided.

The only fair conclusion that can be reached is that federal transfers have fallen significantly short of provincial requirements since 1982-83. This was partly the result of changes in federal policy with regard to financing health care and post-secondary education, (EPF) and partly due to weaknesses or inadequacies of the equalization program.

The following two chapters deal with Established Programs Financing and Equalization in more depth.

CHAPTER IV

ESTABLISHED PROGRAMS FINANCING AND NEW BRUNSWICK'S FINANCES

Background

The federal government has been exercising restraint in its financial support for provincial health care and post-secondary education programs since the early seventies. Beginning in 1972, the federal government began to take steps to reduce its financial commitments to the provinces when it placed a cap on its contributions for post-secondary education. This was followed by a ceiling on federal medicare contributions in 1975.

The introduction of caps and ceilings was contrary to the intent of the original federal-provincial agreements which put these important programs in place. The result was that by the mid-seventies the federal government was only prepared to match provincial spending up to a specified level beyond which the provinces were left with responsibility to finance health care and post-secondary education programs on their own.

The 1977 Fiscal Arrangements replaced federal conditional grants in support of medicare, hospital services and post-secondary education with a new program, Established Programs Financing. Under this program a single cash grant and a transfer of personal and corporate income tax points replaced cost-sharing arrangements.

The EPF arrangement was a compromise. One of its key features was a promise of financial certainty for both the federal and provincial governments. The federal government obtained certainty because no matter how much the provinces might spend on these programs its contributions would not exceed the growth in the national economy. The provinces obtained certainty that the federal government would refrain from applying arbitrary caps and limits to its contributions, and so could plan accordingly.

However, less than two years after it convinced the provinces to accept the new EPF arrangement, the federal government proposed to change its terms and thereby reduce EPF payments to provinces. At that time the provinces successfully resisted cuts to EPF, but the federal government responded by cutting other transfer programs. The Provinces have had much less success in repelling subsequent attempts by the federal government to restrain its EPF contributions since 1981-82.

Implications of Federal Restraint Measures

Changes in the Established Programs Financing Program since 1981-82 account for a significant reduction in federal support for spending in New Brunswick. In this regard, Table 4.1 below shows the estimated revenue loss for New Brunswick as a result of federal policy changes that have been made in EPF since 1982.

TABLE 4.1

ESTIMATED REVENUE LOSSES ASSOCIATED WITH
CHANGES TO ESTABLISHED PROGRAMS FINANCING SINCE 1982

($Millions)

Fiscal Year	EPF Revenue Losses
1982-83	20
1983-84	24
1984-85	29
1985-86	31
1986-87	43
1987-88	56
Total	203

There have been three EPF changes which affected provincial revenues over this period. First, the cash equivalent of 2 equalized tax points, (which were given to the provinces in 1977 as partial compensation for the removal of the 1972 revenue guarantee, and in exchange for the provinces' agreement to waive future claims under the Hospital Insurance and Diagnostic Services Agreement) was removed from the EPF block grant beginning in 1982-83. Second, in conjunction with the federal "6 and 5" program, the "GNP escalator" for the post-secondary education component of EPF was capped at six percent and five percent for 1983-84 and 1984-85. Third, the most recent change, made in 1986, significantly reduced the growth in EPF for that year, and the years ahead.

The third change is part of the new fiscal arrangements and requires some elaboration. When EPF was put in place in 1977, annual increases in provincial spending on health care and post-secondary education ceased to play any role in determining annual increases in federal contributions

to the provinces. Instead, under EPF, yearly increases in federal grants in support of health care and post-secondary education became dependent on the growth in the national economy by means of a "GNP escalator". With the passage of Bill C-96 last year, the "GNP escalator" was allowed to continue to play an important role in determining annual increases in EPF, but the escalator was reduced by two percentage points from what it would have otherwise been each year. New Brunswick's finances have been seriously affected by this change.

Table 4.2 below illustrates the magnitude of the revenue loss to New Brunswick as a consequence of Bill C-96 over the next five years. This table shows that while the impact was relatively small last year, i.e., a $9 million reduction from what the Province would have received, the losses increase each year, totalling $160 million over a five year period.

TABLE 4.2

NEW BRUNSWICK'S ANNUAL EPF REVENUE LOSSES

AS A RESULT OF BILL C-96

	$Millions
1986-87	9.0
1987-88	19.0
1988-89	31.0
1989-90	44.0
1990-91	57.0
Total	160.0

It is always difficult for provinces to cope with reductions in revenue. Bill C-96 was particularly difficult for smaller provinces because it added to the cumulative effect of previous federal measures to restrain EPF payments.

Estimates of the costs of changes to the original EPF program are shown in Table 4.1 above. This table shows that if no changes had been made to the original EPF formula, New Brunswick would have received about $203 million additional federal EPF revenue over the period 1982-83 to 1987-88.*

EPF changes over the years have placed provincial revenue from this program on a substantially lower level than if the original formula had remained unaltered. In addition, the recent recession has produced a significant reduction in the growth of the GNP escalator which ultimately determines the growth of such transfers. When the impact of the recession and the EPF program changes are taken together, the result has left New Brunswick to bear a significantly increased share of the total cost of health care and post-secondary education.

*The attrition in federal support for provincial health care and post-secondary education programs goes back beyond the time frame in Table 4.1. No attempt has been made in this paper to measure the financial cost of restraint measures applied before the introduction of EPF. The difficulty in attempting to determine the cost of federal retrenchment back to 1972 arises because of technical problems associated with making comparisons in a pre- and post-EPF regime.

CHAPTER V
EQUALIZATION AND NEW BRUNSWICK'S FINANCES

Rationale for Equalization

In Canada, there are wide differences in geography, resource endowment, population, industrial structure, income and productivity among provinces. The result is that some provinces have stronger economies than others. This means that there are also differences in the relative ability of provinces to raise revenues and provide services to their citizens. In such circumstances, the only way poorer provinces could provide nationally accepted standards of service on their own would be by levying taxes at higher than national average rates. In such circumstances citizens of poorer provinces would face higher taxes and/or lower standards of services than those in provinces with stronger economies.

If provinces were independent states instead of members of a federation, it would not be expected that differences in levels of taxation and government services should be eliminated. However, provinces are part of a federation, which implies that individuals should be treated equally by their governments, regardless of where they live in their country. In fact, equity demands that individuals, no matter where they reside in a nation, should receive similar standards of public service, and face similar tax burdens.

There are only two ways to ensure such equity. The first is for the national government to assume responsibility for all services. In a unitary state the problem of fiscal disparities does not arise since the central government normally provides broadly uniform services throughout the country and levies uniform taxes in all geographic areas. The only option available to a federation is for poorer federation members or provinces to have their own revenue sources supplemented by the central government, so that they can provide nationally accepted standards of service at national average rates of taxation. The mechanism which has been used to do this for over a quarter of a century in Canada is the federal Equalization Program.

Evolution of Equalization in Canada

The general notion and need for fiscal equalization has been implicitly acknowledged in Canada since Confederation. Ever since that time various federal and provincial governments have been challenged by the persistence of fiscal disparities in the country. Numerous Royal Commissions have examined the problem, from the Duncan Commission in 1924 to the MacDonald Commission of 1985.

The most notable landmark in the evolution of fiscal equalization in Canada emerged as one of the conclusions and recommendations of the Rowell-Sirois Commission of 1937. The Rowell-Sirois Commission investigated and reported on the fiscal structure of Canada. In so doing it assessed the constitutional allocation of revenues and expenditures of the federal and provincial government, the equity and efficiency of the tax system, and federal transfers to the provinces.

The Rowell-Sirois Commission was the first Royal Commission to explicitly recognize the problem posed by fiscal disparities, and to recommend some means of alleviating them. The Rowell-Sirois Commission recommended that the federal government implement a system of National Adjustment Grants. The Commission said:

> "... that all provincial governments be put in a financial position, by National Adjustment Grants from the Dominion, to supply education and welfare services, equivalent in quality (although not necessarily in cost) to the national average, and to maintain developmental expenditures at their individual 1928-31 averages ... and ... the National Adjustment Grants be subject to review by an independent advisory commission every five years, and that this commission would recommend to the Dominion an increase in the adjustment grant whenever a provincial government established that it could not supply Canadian average standards of services and balance its budgets without taxation (provincial and municipal) appreciably exceeding the national average in relation to income."*

Severe opposition from some provinces and the second World War prevented implementation of Rowell-Sirois recommendations in this regard. Nevertheless, the principles espoused by Rowell-Sirois have generally been regarded as an important foundation for Canada's equalization program that was formally established with the Federal-Provincial Tax Sharing Arrangements Act in 1957. Since that time unconditional federal equalization grants have been provided with the objective of ensuring that all provinces have the resources to give their citizens comparable public services without having to resort to above average burdens of taxation.

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*Report of the Royal Commission on Dominion-Provincial Relations, Book II, page 82.

Over the years, since the introduction of the equalization program in 1957, various federal governments, and numerous federal Ministers of Finance have issued similar statements about the purpose and intent of the equalization program. The equalization program has become an accepted fact of Canadian public finance, and the decision to incorporate the principle of equalization in the Canadian Constitution in 1982 confirms the significance of this important feature of the Canadian federal system.

The Constitution is very clear on the purpose of the equalization program and the responsibility of the Government of Canada in this regard. Section 36(2) states that:

> "Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

Ever since its formal inception in 1957, Canada's equalization program has traditionally been authorized for periods of five years at a time. Over the years various formulae have been developed following consultations with the provinces. The purpose of these formulae, which have tended to become extremely complex, has been to provide an objective measure of each province's need for equalization, and at the same time limit the program to that which the federal government can afford.

The equalization formula which had been in place over the period 1982 to 1987 was introduced in 1982. It represented a major departure from the formulae that had been used in the late sixties and the 1970's. In 1982 the standard or level to which provinces were equalized was changed from a national average standard to a standard based on the fiscal capacities of Ontario, Quebec, Manitoba, Saskatchewan and British Columbia.

The 1982 formula, by its nature, was supposed to change the distribution of equalization entitlements among the recipient provinces. As a result two provinces, Manitoba and Quebec, were not originally expected to be given as much in the form of equalization grants from this formula as they had been receiving from the national average formula that it was replacing. In recognition of this expectation, the 1982 equalization program also contained a special "transition provision" which was added to the new formula so that these provinces would be able to adjust to the relatively lower equalization entitlement with the new formula. While this special provision was not expected to play a significant role in terms of the distribution of equalization entitlements, it in fact played a substantial role, and led to a significant change in the distribution of equalization entitlements among the provinces. It also led some provinces, including New Brunswick, to question the adequacy of the equalization program.

Revenue Shortfalls With the 1982 Equalization Program

New Brunswick has contended with a difficult situation since 1982-83. As noted in Chapter IV, changes in the original EPF formula have contributed to the Province's recent fiscal problems. The remainder of this Chapter examines certain deficiencies in the equalization program, which have also been significant in this respect.*

Over the past five years it has become obvious that the equalization program that was introduced in 1982 did not deliver the revenues originally expected. In February, 1982, equalization forecasts were made by the federal government to illustrate the financial impact of the new five province standard equalization formula. Recent data prepared by the federal government show that total federal equalization payments have been significantly lower than originally anticipated. These data also show that New Brunswick received substantially reduced payments for each of the past five years. Table 5.1 shows the original 1982 forecast of equalization entitlements, the latest federal estimate, and the difference between those estimates for New Brunswick.

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*A factor unrelated to changes to the formula or the economy is that the Province's population has fallen relative to the country as a whole. The money owed Canada due to the overpayment of equalization in 1980 and 1981, because of an overestimate of population, was forgiven as part of the settlement of Fiscal Arrangements in 1982. However, the revenue impact of the lower population has resulted in somewhat lower equalization entitlements in the years since 1981-82.

TABLE 5.1

NEW BRUNSWICK'S EQUALIZATION ENTITLEMENTS[1]

($Millions)

Fiscal Year	Original 1982 Estimate	Latest Estimate	Difference
1982-83	490	488	-2
1983-84	554	517	-37
1984-85	616	540	-76
1985-86	684	613	-71
1986-87	755	635	-120

[1]Estimates produced by the federal Department of Finance in February, 1982, and as of March 1987. Estimates include transition payments where applicable.

Similar results have occurred for the other receiving provinces, but it is noteworthy that payments to New Brunswick and the Atlantic Provinces generally, are the furthest from those which were originally forecast with the introduction of the 1982 equalization formula. This is shown in Table 5.2 which indicates that over the five year period Quebec and Manitoba together received about 91.8% of projected entitlements, while the Atlantic Provinces only received about 85.5% of projected entitlements. New Brunswick received 90% of expected entitlements. As a consequence, there has also been a substantial change in the distribution of equalization payments since the original forecasts were prepared. New Brunswick and the other Atlantic Provinces have received a smaller share of equalization than was expected in 1982 while Quebec and Manitoba received a larger than expected share.

TABLE 5.2

COMPARISON OF EQUALIZATION ENTITLEMENTS

1982 PROJECTIONS AND LATEST ESTIMATES

($Millions)*

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Man.	Total
1982-83							
February 1982 Projection	522	124	606	490	2,552	431	4,725
Latest Estimate	464	118	574	488	2,782	439	4,865
1983-84							
February 1982 Projection	588	140	693	554	2,825	457	5,257
Latest Estimate	540	125	605	517	2,977	466	5,230
1984-85							
February 1982 Projection	651	156	775	616	3,143	470	5,810
Latest Estimate	578	129	620	540	3,074	480	5,422
1985-86							
February 1982 Projection	723	172	862	684	3,478	488	6,407
Latest Estimate	671	136	606	613	2,808	415	5,249
1986-87							
February 1982 Projection	799	189	953	755	3,831	538	7,067
Latest EStimate	696	144	647	635	2,828	448	5,398
1982-1986							
February 1982 Projection	3,283	781	3,889	3,099	15,829	2,384	29,265
Latest Estimate	2,949	652	3,052	2,793	14,469	2,248	26,163
Latest Estimate as a Percentage of February 1982 Projection	89.8%	83.5%	78.5%	90.1%	91.4%	94.3%	89.4%

*Estimates produced by the federal Department of Finance in February, 1982 and as of March 1987. Estimates include transition payments where applicable.

There are several reasons for the discrepancies between the original 1982 forecasts and the most recent data. First, there were a number of tax base changes in the equalization formula which were implemented after February, 1982. In addition, inflation rates were significantly lower than were assumed in the February 1982 estimates. Clearly, part of the discrepancy can be explained by these changes. There are additional factors, however, which are explained below.

The Impact of Provincial Deficits on Equalization Payments

The Canadian equalization program, from its formal inception in 1957, has always been a revenue based system even though the ultimate objective of the program has been to ensure that all provinces are able to provide a comparable level of public services (i.e., expenditures). On the assumption that the cost and need for public services is similar throughout the country, the Canadian equalization program was developed around the proposition that if provinces have equalized revenue raising capacity, each province will have the financial capacity to provide services comparable to the provinces as a whole. More accurate and complete data exist on revenues and revenue raising capacity than on expenditures. Consequently the revenue based approach allows for more accurate interprovincial comparisons than is possible using expenditure data.

In order for the equalization program to meet its objectives, there must be some balance between provincial local spending and provincial local revenues in all the provinces.* If revenues on which the formula is based, fall short of spending, then equalization payments will also fall short.

One of the consequences of the latest recession is that provincial local sector revenues have not kept pace with provincial local spending. This change in circumstances has placed equalization recipient provinces in a very difficult dilemma. On the one hand, total provincial local spending has continued to grow, and individual provinces have had to respond to pressure to keep up with this growing level of expenditures by the provinces as a whole. At the same time however, much of these increased expenditures in the provincial local sector has been financed by deficits, and not by increases in revenues. As a result, since it is total provincial local revenues that drive the equalization program, equalization entitlements have not kept pace with overall provincial local expenditure growth. This has meant that the standard of services that a provincial government is expected to maintain has increased, but the revenue available to do so through equalization has not kept pace.

Table 5.3 contains estimates of consolidated provincial local per capita revenues and expenditures for the ten provinces.

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*See footnote explaining the term "provincial local" on page 14.

TABLE 5.3

CONSOLIDATED PROVINCIAL LOCAL EXPENDITURES, REVENUES AND DEFICITS, ALL PROVINCES

($ Per Capita)

	Expenditures ($)	Revenues ($)	Surplus (Deficit) ($)	Revenues as a Percent of Expenditures ($)
1977-78	2,302	2,268	(34)	98.6
1978-79	2,530	2,534	4	100.2
1979-80	2,766	2,833	67	102.4
1980-81	3,147	3,148	1	100.0
1981-82	3,584	3,595	11	100.3
1982-83	4,128	3,818	(310)	92.5
1983-84	4,400	4,196	(204)	95.4
1984-85	4,571	4,437	(134)	97.1
1985-86	4,930	4,702	(228)	95.4
1986-87	5,167	4,891	(276)	94.7

SOURCE: Statistics Canada

Table 5.3 shows that from 1977-78 to 1981-82 provincial local governments as a whole operated with a balanced budget. Indeed, over that time period the provinces collectively managed their affairs such that provincial local per capita revenues covered close to 100% of total provincial local per capita spending.

Beginning in 1982-83, circumstances began to change when revenues began to grow much more slowly than expenditures. As a result through 1982-83 and 1983-84, a significant gap began to emerge between expenditures and revenues. In the recession years only 94% of provincial local expenditures were covered by provincial local revenues, as provinces chose, or were forced by events, to run large deficits. While economic conditions have improved in recent years, this trend nonetheless, continued through 1984-85, 1985-86 and 1986-87. Despite the relatively strong recovery in the past three years, provincial local revenues were still only making up 95.7% of provincial local expenditures compared to the balanced and surplus conditions of the late seventies and early eighties.

This overall change from surplus to deficit conditions in the provincial local sector has had a serious effect on the equalization entitlements of recipient provinces. In this regard it is estimated that if provinces had not run abnormally high deficits since 1982-83, but had instead financed their increasing expenditures through taxation, revenues to be equalized would have been considerably higher in each of the past five years. Had this occurred, New Brunswick's equalization entitlements would have been much higher than they were, as can be seen in Table 5.4.

TABLE 5.4

NEW BRUNSWICK'S EQUALIZATION SHORTFALLS DUE TO CHANGE FROM SURPLUS TO DEFICIT CONDITION IN PROVINCIAL LOCAL SECTOR

($Millions)

1982-83	55
1983-84	38
1984-85	27
1985-86	45
1986-87	56
Total	220

SOURCE: New Brunswick Department of Finance

The transition payments in the 1982 fiscal arrangements softened the impact of these equalization shortfalls to some extent for a few years, as New Brunswick and most provinces received large transition payments for 1982-83, 1983-84 and 1984-85.* In fact, however, the transition payments masked the underlying weakness in the equalization program. Once transition was over in 1984-85, the full impact of deficit financing by provincial governments became quite clear. Equalization payments for all recipient provinces have been permanently ratcheted down to "abnormally low" levels relative to what might "normally" have been expected if provincial local budgets generally had remained balanced.

*Transition payments were a special feature of the 1982 equalization program. These payments were incorporated into the program in 1982 to enable provinces to more easily adjust to the move from the national average to the five province standard equalization formula.

The impact of the movement to deficit financing on equalization entitlements, and the resulting effect on the objectives of the equalization program, can be illustrated by looking at New Brunswick's equalization entitlements in relation to the revenues and expenditures of all provinces. The equalization program is supposed to provide sufficient revenues so that provinces that need such payments are able to keep up to the national, or all province average. If the program were working properly, one would not expect year-over-year growth in New Brunswick's equalization entitlements to fall significantly below the year-over-year growth in expenditures of the provinces as a whole. Nevertheless, that is exactly what has happened.

Table 5.5 contains estimates of New Brunswick's per capita equalization entitlements together with estimates of total provincial revenue and expenditure statistics contained in Table 5.3.

TABLE 5.5

CONSOLIDATED PROVINCIAL LOCAL EXPENDITURES AND REVENUES FOR ALL PROVINCES, AND NEW BRUNSWICK'S EQUALIZATION ENTITLEMENTS

($ Per Capita)

	Provincial Local Expenditures ($)	Provincial Local Expenditures (Growth Rate in Brackets) (%)	Provincial Local Revenues ($)	Provincial Local Revenues (Growth Rate in Brackets) (%)	New Brunswick's Provinces Equalization ($)	New Brunswick's Provinces Equalization (Growth Rate in Brackets) (%)
1977-78	2,302		2,268		400	
1978-79	2,530	(9.9)	2,534	(11.7)	481	(20.3)
1979-80	2,766	(9.3)	2,833	(11.8	449	(-6.7)
1980-81	3,147	(13.8)	3,148	(11.1)	533	(18.7)
1981-82	3,584	(13.9)	3,595	(14.2)	639	(19.9)
1982-83	4,128	(15.2	3,818	(6.2)	634	(-0.5)
1983-84	4,400	(6.6)	4,196	(9.9)	717	(12.7)
1984-85	4,571	(3.9)	4,437	(5.7)	779	(8.6)
1985-86	4,930	(7.9)	4,702	(6.0)	834	(7.1)
1986-87	5,167	(4.8	4,891	(4.0)	884	(6.0)

SOURCE: Statistics Canada

There are a number of observations that can be drawn from the information in Table 5.5. From 1977-78 to 1981-82 provincial local per capita spending increased by 13.9% per year and provincial local revenues were increasing by 14.6%. Over the same period New Brunswick's equalization more than kept pace by increasing by about 14.9% per year. This contrasts sharply with what has occurred since 1981-82. From 1981-82 to 1986-87 provincial local per capita spending has increased by about 8.8% per year and provincial local per capita revenue by about 7.2% per year. Over this period, New Brunswick's per capita equalization entitlements have grown by 7.6% per year, marginally higher than revenue growth in all provinces, but substantially lower than the growth in provincial local spending in all provinces.

Increased deficits in the wealthier provinces have put New Brunswick and other have-not provinces in a fiscal squeeze. Equalization entitlements for these provinces have not kept up to to their expenditure needs. If equalization payments are to enable recipient provinces to retain some degree of relativity between themselves and the country as a whole in terms of spending on public services, it is clear, that during the last five years at least, the program has failed to do this as far as New Brunswick is concerned.

The Cost of Inaccurate Measures of Fiscal Capacity

The change in provincial local fiscal policies noted above has had a negative effect on New Brunswick's equalization, and is responsible for a large part of the shortfall in the Province's entitlements. Another factor which has contributed to the equalization shortfalls to New Brunswick is the failure of the current revenue based equalization formula to correctly measure the ability of provinces to raise revenue (i.e., their fiscal capacities).

In arriving at measures of fiscal capacity, the equalization formula attempts to determine, on a standardized basis, the total amount of revenue that each province could raise from those revenue sources that are available to the provinces. For each revenue source an all-province average provincial tax rate is applied to the estimated value of each province's tax base, as defined by the formula. The resulting revenue yields are then summed to produce a total that is considered to be a measure of each province's fiscal capacity. Those provinces that have a fiscal capacity below a predetermined standard are eligible for an equalization payment to make up the difference.*

The current equalization standard is the combined fiscal capacities of five provinces, namely, British Columbia, Saskatchewan, Manitoba, Ontario and Quebec. Previous to 1982, eligible provinces were equalized to a higher standard, i.e., to the national average of all provinces.

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*The provincial revenue sources that are subject to equalization are shown in Appendix 1.

To get a satisfactory measure of fiscal capacity, accurate measures of each province's tax base must be made. If the tax bases ascribed to a province are not accurately measured, its fiscal capacity will be wrongly assessed, and that province's need for equalization will not be correctly determined. The fact that the 1982 program failed to provide proper measures for a number of the tax bases was a major shortcoming of the equalization formula that has been used for the past five years.

There are a number of ways the equalization program's failure to measure fiscal capacity could be illustrated. One way would be to look at the equalization formula's measurement of relative fiscal capacity and compare this with a province's relative economic strength as measured by Gross Domestic Product (GDP). Table 5.6 shows average fiscal capacity indices for New Brunswick as measured by the equalization formula, and New Brunswick's per capita GDP in relation to the national average per capita GDP.

TABLE 5.6

NEW BRUNSWICK ECONOMIC AND FISCAL INDICATORS

	Average Relative GDP/Capita	Average Relative Fiscal Capacity
1972-77	67.9	68.9
1977-87	67.1	64.3
1982-86	64.1	66.0

If fiscal capacity were measured correctly it would be reasonable to expect that if a province's GDP per capita fell in relation to the Canadian average, its relative fiscal capacity would also fall since it would seem that under such circumstances such a province would have a diminished ability to finance its activities.

The Canadian equalization program in fact operated in this fashion up to 1981. In the five year period 1977 to 1981 New Brunswick's GDP per capita fell in relation to the national average, and during that time period its fiscal capacity as measured by the equalization program also fell. This is in sharp contrast with what has happened since 1981. In the 1982 to 1986 period New Brunswick's relative economic strength as measured by GDP per capita fell even further, yet its fiscal capacity as measured by the equalization formula increased substantially. Such inconsistency is evidence that New Brunswick has been deprived of considerable equalization revenues over the past five years.

For some time the New Brunswick Department of Finance has argued that a number of the tax base definitions in the equalization formula were inaccurate representations of what provinces have available to tax. New Brunswick has contended that the formula has been overestimating its fiscal capacity, and in so doing, understating the amount of equalization that it should receive. This view was supported by the findings of a recent federal-provincial review of the equalization tax bases. As a result, the federal Department of Finance proposed that changes should be made to the tax bases for the sales tax, the property tax, lottery revenues, potash revenues, and coal revenues to make these tax bases more realistic representations of what provinces have available to tax.

The federal Department of Finance has estimated that full implementation of its suggested changes to the tax bases would result in New Brunswick's equalization being increased by $41.6 million in 1987-88.* This amount can be considered a good measure of the equalization shortfall that New Brunswick has had to bear each year as a result of inaccuracies in the measurement of fiscal capacity in the recent past.

Table 5.7 below contains an estimate of the annual value of the proposed tax base changes had they been carried back to 1982-83.

TABLE 5.7

NEW BRUNSWICK'S EQUALIZATION SHORTFALLS

DUE TO INADEQUATE MEASUREMENT OF FISCAL CAPACITY

($Millions)

1982-83	30.8
1983-84	31.2
1984-85	34.1
1985-86	36.6
1986-87	39.7
Total	172.4

Table 5.7 shows that as a minimum New Brunswick has been deprived of at least $172 million because of inadequacies in six out of 39 of the tax bases over the past five years. This is believed to be a minimum amount because there are other tax bases which may also have serious flaws, and the federal proposal to improve the property tax base, while dealing with problems in measuring the value of farm and residential property, did not correct obvious shortcomings with respect to commercial property. Putting this issue aside however, the information in Table 5.7 is further strong evidence that New Brunswick's equalization payments should have been significantly higher for each of the last five years.

*Only one-half of this will be paid to the Province in 1987-88.

CHAPTER VI
REPORT ON THE LATEST ROUND OF NEGOTIATIONS

Background

Over the past three years the New Brunswick Department of Finance has consistently argued that the federal transfer system was inadequate. In fact, as far back as 1983-84, as the Province began to struggle with its deficit, it became very clear that increased federal transfer payments were essential if New Brunswick was to get back to a healthy financial situation. It was from this perspective that New Brunswick approached the latest round of negotiations with the federal government concerning the fiscal arrangements for the 1987 to 1992 period.

In December 1984, shortly after the current federal government took office, New Brunsiwck Finance Minister the Honourable John B. M. Baxter, Q.C., met with the new federal Minister of Finance the Honourable Michael Wilson. At that time New Brunswick pointed out that the equalization formula was not operating fairly, and that it was not providing sufficient revenue to enable the Province to provide reasonably comparable levels of public service at reasonably comparable levels of taxation. In early 1985 the Province met with the federal Minister once again, and at that time reiterated that the equalization formula was not working as it should and that changes should be made.

These representations met with some success, and the federal government responded in April 1985 with a special supplementary equalization payment to all recipient provinces. New Brunswick's supplementary payment was $20 million. This payment was made by the federal government even though it did not have to do so under existing legislation, partly because the federal government itself believed that the 1982 equalization formula was not working as intended.*

Despite the fact that the federal government agreed to the supplementary payment, it was not prepared to deal with the underlying technical problems with the equalization formula that had been raised by New Brunswick at that time. Instead, the federal Minister undertook to ensure that New Brunswick's concerns about the equalization formula would be seriously considered prior to finalizing the formula for the five year period 1987 to 1992.

Negotiations on Established Programs Financing

When the supplementary equalization payment was announced in April 1985, it looked as if the federal government had become receptive to the view that the existing federal transfer system was not adequate. However, just one month later in the May 1985 federal budget, the federal government announced it would be taking steps to slow the rate of growth in transfer payments to the provinces. With this announcement, the federal government did not give any indication how it intended to apply restraint, although it seemed that federal payments in support of health care and post-secondary education

*Appendix 4 contains a copy of a letter from the Honourable Michael Wilson to Honourable John B. M. Baxter, Q.C. in which the federal Minister acknowledges that New Brunswick's representations were important factors in the decision to pay supplementary equalization.

would be the target, i.e., EPF. It was clear, however, that increased federal assistance would be very difficult to achieve.

Through the last half of 1985 and into the Spring of 1986, federal-provincial discussions focussed on the plan to reduce the rate of growth in federal transfers as announced in the May 1985 Budget. It became apparent very early in those discussions that despite objections of the provinces, EPF was to be changed beginning in 1986. It also became clear that the federal government was not prepared to enrich the equalization program when it came up for renewal in 1987.

The federal government persisted with its plan to change the EPF formula, and legislation to limit the rate of growth in EPF payments to the provinces was approved by Parliament in the Summer of 1986. EPF was changed over the objections of all the provinces, the Canadian Medical Association, the Canadian Association of Universities and many other groups. The Province of New Brunswick strongly objected to the changes in EPF. The Provincial Legislature adopted a resolution that criticized the changes to EPF, and the Province submitted a formal brief to the Parliamentary Committee responsible for reviewing the legislation which put the EPF changes into effect. This brief is attached as Appendix 5. In spite of objections the EPF changes were passed into law.

Negotiations on Equalization

With respect to the discussions on the equalization program, New Brunswick took the position that the program was failing to meet its constitutional obligations because of shortcomings in the design of the formula. The equalization program is designed to make up for a province's inability to raise tax revenue from its own economy. The equalization formula operates by assessing each province's ability to raise revenue from virtually all revenue sources open to the provinces, and comparing how each province measures up in this respect to a predetermined standard.* The most important operation performed by the equalization formula is the comparison of each province's ability to raise revenue. If the formula does not accurately measure a province's fiscal capacity to raise its own revenue, it will overestimate or underestimate the amount of equalization that such a province requires.

New Brunswick had argued for some time that one of the main reasons poorer provinces do not get enough equalization is because the formula overestimates the ability of these provinces to raise revenue. Proposals to correct this technical deficiency in the formula were put forward by New Brunswick in early 1985 but these were not accepted at that time. It was not until early 1986 that federal and provincial officials began to jointly examine a number of technical matters pertaining to the equalization program.

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*As noted above the standard is the average of British Columbia, Manitoba, Ontario, Quebec and Saskatchewan, the so-called five province standard.

This joint examination turned out to be the most important aspect of this round of discussions about the equalization program. For over a year federal and provincial Finance officials concentrated their efforts on a close technical examination of the way in which the equalization formula measures a province's ability to raise revenue. This work focussed on the tax bases of six out of the thirty nine revenue sources subject to equalization. From the outset, it was the Province's belief that such a review would point out serious shortcomings in the formula, and that dealing with these would lead to significantly increased equalization payments to New Brunswick.*

The technical review of the equalization tax bases was completed in early September 1986 at which time the federal Department of Finance proposed that a number of changes should be made to improve the equalization formula. These changes, if fully implemented, showed that New Brunswick would benefit with about $41 million in extra equalization revenue per year beginning in 1987-88. At both the officials' and Ministerial levels, New Brunswick strongly supported the technical changes proposed by the federal Department of Finance. However, New Brunswick also proposed an additional technical amendment to the property tax base, which was consistent with the other proposed changes, and which would have added a further $17 million per year to New Brunswick's equalization payments.**

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*See Appendix 5 for copies of papers dealing with technical issues tabled by New Brunswick.

**The federal proposal to improve the property tax base dealt with deficiencies in the measurement of farm and residential land values but did not correct obvious shortcomings with respect to commercial land values. New Brunswick proposed a mechanism that would have accomplished this task.

The federal Minister of Finance indicated at Finance Ministers' meetings in Montreal and Edmonton in the Fall of 1986, that he was prepared to recommend that the federal Cabinet accept the package of proposed technical improvements to the equalization formula. These changes would have added about $175 million to the annual cost of the equalization program of which New Brunswick would receive about $41 million. The federal Minister also agreed in principle with New Brunswick's additional proposed change to the property tax base, but he was not prepared to adopt this technical change in 1987-88. Instead he said he would consider the change in more detail over the next year or two. New Brunswick argued that the additional improvement with respect to commercial property should also be part of the technical package going to the federal Cabinet, because the proposed changes did not deal with all of the equalization program's shortcomings, and another opportunity to review the formula might not occur for five years.

In general the Atlantic Provinces and Manitoba were basically in agreement with the technical amendments which the federal Minister had proposed. These provinces also generally supported New Brunswick's proposed technical amendment to the property tax base. Quebec did not agree with the federal proposal, primarily because it was not satisfied with the distribution of equalization payments that resulted from such changes, even though it would receive more equalization as a result.

Manitoba and Quebec were also pressing for a major enrichment of the equalization program in these discussions. While this may have had certain appeal, it was clear that this was extremely unlikely to happen. New Brunswick did not support a major enrichment of the program in the discussions

because it was felt that such pressure by recipient provinces, in a period of general restraint, would probably weaken overall support for the equalization program. New Brunswick did, however, raise one other matter of importance to all recipient provinces. This concerned the results of the 1986 Census, and how they might affect transfer payments in the years ahead. New Brunswick was the first province to bring this issue to the discussions.

When the results of the 1981 Census became available five years ago, it was discovered that intercensal population estimates for 1980 and 1981 had been overstated, and as a result New Brunswick had received about $61 million in equalization which, under normal circumstances, it would have had to repay. At that time as part of the negotiated settlement on the 1982 equalization program, the Province was able to obtain relief from having to repay this money to the federal government. New Brunswick was concerned that the same problem could arise again in 1986 and, if the Census error in 1986 were of the same order of magnitude as 1981, it might have had to repay over $100 million to the federal government in 1987-88.

At the December 1986 Finance Ministers' meeting New Brunswick asked the federal Minister to consider the possibility of forgiving repayment of any amounts that might be owed by the Provinces as was done in 1982 for equalization payments.* At that time and throughout the rest of the year, the federal Minister remained non-committal. While acknowledging that the 1986 Census might lead to large repayments by the provinces, he would not give any undertaking that the federal government would forego recovery of past overpayments for equalization.

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*See Appendix 6 for copies of statements made by New Brunswick's Minister of Finance at Finance Ministers' meetings in which equalization payments and EPF were discussed.

This was disappointing to the provinces, who were now put in a position where any gains that may have been forthcoming as a result of proposed tax base improvements would have been lost if large recoveries were required of them in 1987-88. To make matters worse, the federal Minister announced at the Toronto Finance Ministers' meeting in December 1986, that while he was still prepared to make the tax base changes which had been identified and agreed to earlier, the Government of Canada was now only prepared to pay out half the value of such improvements in 1987-88, with full implementation in the years that followed.

In addition, the federal Minister informed the provinces that the federal government intended to retain the GNP cap on equalization payments for the 1987 to 1992 period. The GNP cap was one of the most objectionable features of the 1982 program as far as the provinces were concerned. The GNP cap was put on the equalization formula in 1982 so that equalization payments would not grow at a faster rate than the growth in the economy.

The provinces strongly opposed this ceiling when it was made part of the program in 1982 because it interferred with the ability of the formula to reflect changing economic and fiscal circumstances. The application of a GNP cap meant that equalization receiving provinces would not get the full benefit from economic growth in the standard provinces during times when those provinces' economies performed better than the country as a whole. For the provinces, retention of the GNP cap in the 1987 formula was of even more significance than in 1982, since any losses recipient provinces may have suffered because of inadequacies of the 1982 formula could be prevented from being made up if the cap were retained.

The modification in the federal position with respect to the improvements to the tax bases, coupled with the financial risks associated with the possibility of having to make large repayments as a result of the Census, and the reimposition of a GNP cap, brought the formal discussions on the equalization formula to an impasse. The provinces felt that the federal government, by implementing only half of the value of the tax base improvements, and by remaining non-committal about forgiving probable overpayments for prior years, was putting them in a position whereby the improved equalization program that had been agreed to earlier would not provide much additional financial help as far as their revenues were concerned.

As 1986 came to an end and during the early months of 1987, the provinces made numerous representations to the federal government on these issues. New Brunswick made a number of bilateral interventions, as well as representations with the other Maritime Provinces about the equalization legislation that the federal Minister was in the process of finalizing. On these occasions, New Brunswick urged the federal Minister to adopt the following course of action:

1) to forgive repayment of equalization and EPF overpayments that became evident because of results of the 1986 Census;

2) to deal with the commercial property component of the property tax base in 1987-88 for implementation in 1987-88;

3) to implement all of the tax base changes in 1987-88;

4) to remove the GNP cap on equalization in the 1987-1992 period.

5) to continue to analyze the equalization program with a view to improving its effectiveness in terms of its Constitutional objectives, and to adopt such improvements at the time they are agreed upon.

At the March 1987 Finance Ministers' meeting, which was held the day after legislation for the new equalization formula was placed before Parliament, the provinces had the first opportunity to see specifically what the federal government intended to do with the equalization program for the next five years. At that meeting, New Brunswick reiterated its concerns about the program and expressed concern that the new equalization legislation did not go far enough in addressing all of the issues that had been raised about the program.

CHAPTER VII
THE 1987 FISCAL ARRANGEMENTS: WHAT THEY MEAN TO NEW BRUNSWICK

Fiscal arrangements for the 1987-92 period are now in place. Bill C-44 which amended the fiscal arrangements act, was given Royal Assent on April 14, 1987. This Chapter provides an overview of the most important changes in Fiscal Arrangements that will result from Bill C-44, as well as an outline of the financial implications of those changes.

Changes in the Equalization Program

Concerning equalization the amendments to the fiscal arrangements legislation provide for:

1. an extension of the equalization program for the period 1987-88 to 1991-92. The five province standard formula has been retained, and the program will not return to a national average standard;

2. a two year phased implementation of a number of technical changes to the formula. Beginning in 1987-88 tax base changes will be put in place for six revenue sources, the most important being the property tax base;

3. removal of succession duties and gift taxes from the formula as a separate revenue category since they are no longer important provincial revenue sources.

4. retention of the "floor provision" of the 1982 formula, but change the base year from 1983 to 1987. This feature ensures that equalization in any year after 1988 can be no less than 95% of the previous year's level. This is similar to the floor provision in the 1982 formula;

5. retention of the GNP cap on growth in total equalization entitlements, but change base year from 1982 to 1988. This means total equalization cannot grow faster than GNP after 1988. A similar feature was in effect with the 1982 formula;

6. repeal of transition payments associated with 1982 formula since such payments are no longer required;

7. forgiveness of Census related overpayments for 1985-86 and 1986-87 to the extent that such amounts exceed future increases for the same two years that may arise as a result of changes in financial and economic data which become available after March 31, 1987.

Financial Impact of Changes in Fiscal Arrangements

New Brunswick's revenues will be affected by these changes in the equalization program. The following table illustrates the financial impact on New Brunswick.

TABLE 7.1

FINANCIAL IMPACT ON NEW BRUNSWICK OF CHANGES TO EQUALIZATION PROGRAM

($Millions)

	1987-88	1988-89
Value of Tax Base Changes[1]	20.5	42.4
Value of Population Forgiveness[2]	30.0	0.0
Total Impact of Changes to Equalization Program[3]	50.5	42.4

[1]Estimates of Federal Department of Finance.

[2]Estimate of New Brunswick Department of Finance; these amounts could be more or significantly less.

[3]These amounts are for illustrative purposes only. They attempt to show the difference between the 1982 equalization program and the 1987 program using similar economic and fiscal data. Future changes in economic and fiscal data will change these values. Nevertheless, these estimates can be used to make valid relative comparisons at this point in time.

Table 7.1 shows that New Brunswick's revenues will be $50.5 million higher in 1987-88 than they would otherwise have been, as a result of the changes in the equalization program. For 1988-89 the Province's revenue will be $42.4 million higher.

When put in the context of the other equalization receiving provinces, New Brunswick did relatively well as a consequence of the changes in the equalization program. This is shown in Table 7.2 which shows the financial impact on provinces of changes to the equalization tax bases in per capita terms.

TABLE 7.2

FINANCIAL IMPACT ON PROVINCES OF CHANGES TO EQUALIZATION TAX BASES

($ Per Capita)

	1987-88	1988-89
Newfoundland	21	45
Prince Edward Island	14	28
Nova Scotia	10	19
New Brunswick	29	59
Quebec	6	12
Manitoba	5	10
Federal Per Capita Cost	9	18

SOURCE: Federal Department of Finance.

Another way of looking at how New Brunswick fared as a result of changes to the equalization program can be seen in Table 7.3.

TABLE 7.3

PROVINCIAL SHARE OF CURRENT EQUALIZATION PAYMENTS COMPARED TO SHARE OF FINANCIAL BENEFITS FROM CHANGES TO EQUALIZATION TAX BASES

	Share of Total Equalization Payments 1986-87(2)	1987-88 Share of Financial Benefits Due to Amendments	1988-89 Share of Financial Benefits Due to Amendments
Newfoundland	12.8%	13.8%	14.3%
Prince Edward Island	2.6%	2.0%	2.0%
Nova Scotia	11.7%	9.6%	9.5%
New Brunswick	12.2%	23.1%	23.8%
Quebec	52.3%	45.8%	44.4%
Manitoba	8.4%	5.6%	5.9%

SOURCE: Federal Department of Finance

Table 7.3 shows that, when compared to the share of total equalization it has been receiving, New Brunswick will receive by far the largest share of financial benefits due to the latest changes in the formula. It is clear from this table and Table 7.2 that New Brunswick, among the recipient provinces, will get the greatest amount of benefits as a result of the changes to the equalization program. The problem, however, is that even with such a relatively satisfactory outcome in respect of the equalization program, the Province's overall revenue position will see only marginal improvement. This is seen in Table 7.4.

TABLE 7.4

OVERALL FINANCIAL IMPACT ON NEW BRUNSWICK OF RENEWED FISCAL ARRANGEMENTS

($Millions)

	1987-88	1988-89
Equalization Gains	+20.5	+42.4
Population Forgiveness[1]	+30.0	
EPF Losses[2]	-19.0	-31.0
Net Change in New Brunswick Revenues	31.5	+11.4

[1]This does not represent new revenues, but is an estimate of the amount the Province would have to repay in 1987-88 if overpayment not forgiven.

[2]There was also a $9 million loss in 1986-87

SOURCE: Federal Department of Finance, and estimates of the New Brunswick Department of Finance.

Table 7.4 shows what the overall financial consequences of the latest changes in fiscal arrangements will mean to New Brunswick for the next two years. This table shows that after the current year, the net impact on the Province's revenues is relatively small. While equalization estimates for the years following 1988-89 have not been provided, it is expected that by that time, EPF losses associated with Bill C-96 will exceed any equalization gains to the Province. At that time New Brunswick will join the other provinces and be in a net loss position.

Changes in Other Components of the Fiscal Arrangements

This report has focused on EPF and equalization because these programs represent transfer payments, and have the most important financial implications for New Brunswick. As noted in Chapter II however, there are other programs and federal-provincial agreements which fall within the purview of the federal-provincial fiscal arrangements legislation. This section provides a brief overview of the changes which Bill C-44 made in respect to these other matters.

Federal-Provincial Tax Agreements

Sections of the Act that deal with authority of the Government of Canada to enter into Federal-Provincial Income Tax Collection Agreements and Reciprocal Taxation Agreements have been left intact by Bill C-44. The Province has, however, just completed negotiations for a five year renewal of the Canada-New Brunswick Reciprocal Taxation Agreement. These negotiations, while related to the fiscal arrangements, were conducted separate from the discussions on the transfer programs.

Under the Reciprocal Taxation Agreement the federal government pays grants-in-lieu of provincial consumption taxes, i.e., retail sales tax, gasoline and motive fuel tax and motor vehicle fees. The provinces, for their part, are committed to paying federal taxes on their purchases. The new Reciprocal Taxation Agreement will have to be renegotiated before its expiry date in 1992 if the federal government adopts a new multi-stage sales tax. The Province may also want to re-examine its participation in the Canada-New Brunswick Income Tax Collection Agreement if it transpires that federal tax reform initiatives result in a loss in provincial revenues.

Fiscal Stabilization

Fiscal stabilization is a program by which the federal government makes payments to provinces that suffer an absolute year over year revenue decrease as a result of a sudden economic downturn. To date only one province has ever received payments under this program, although a number of provinces currently have applications for such payments before the federal government. Bill C-44 contained a number of provisions with respect to this program. These:

1. provide for retention of the Fiscal Stabilization Program to 1992;

2. provide for a change in stabilization payment from a cash grant to:

   (i) cash grant up to $60 per capita;
   (ii) no interest loan to cover any additional amounts over and above 2(i).

3. provide for a number of changes to make the program easier to administer.

Administrative Matters

Bill C-44 also contained a number of sections dealing with certain administrative matters with respect to fiscal arrangements. Amendments in this respect:

1. provide for extension of the personal income tax revenue guarantee from March 1987 to March 1992. This program provides guaranteed cash payments to provinces if federal income tax changes result in a one percent or greater decline in federal basic tax, i.e., the provinces income tax base;

2. provide for repeal of sections dealing with undistributed income on hand since they are no longer required;

3. provide for repeal of sections dealing with levelling adjustment under the original 1977 EPF program since they are no longer required;

4. provide for extension of deadlines for tabling the annual report on Post-Secondary Education by the Secretary of State.

Conclusion

Federal transfer payments have been, and continue to be of critical importance to New Brunswick. This paper has reviewed New Brunswick's views with respect to these payments, and the issues it raised in the latest round of discussions concerning federal-provincial fiscal arrangements.

This paper has argued that New Brunswick's current fiscal situation is in part due to the fact that federal transfer payments have been making a smaller than traditicnal contribution to the Province's public finances. The paper has shown that if federal transfer payments in support of public spending in New Brunswick had remained at the level of the decade prior to 1982, New Brunswick's fiscal position would have been improved significantly.

Changes in the funding arrangements for health care and post-secondary education have contributed to the lower than "traditional" level of federal assistance to New Brunswick. As a result New Brunswick has been forced to bear an increased share of the cost of its health care and post-secondary education system.

The most important factor which has led to the diminishing role of the federal government has been as a consequence of very serious and significant shortfalls in equalization payments to New Brunswick for the last five years. These shortfalls were the result of two failings on the part of the equalization formula. It has been shown that the formula has not produced the kind of entitlement growth that might have been expected because the provinces as a group have been financing spending increases in recent years by deficits and not be increasing revenues which in turn drive the equalization program. Equally important, it has also been shown that the equalization formula has failed to measure fiscal capacity accurately, and by so doing has deprived some provinces from their fair share of equalization entitlements.

New Brunswick has had to cope with a very difficult financial situation for the past five years. Increasing deficits and debt, tax increases and spending cuts have become all too familiar. This situation arose and persists because of the 1982 recession, and as a consequence of shortcomings in the federal transfer system.

The next five years are critical to New Brunswick. However, with the EPF changes now in place as a result of Bill C-96, and the changes that have been approved for the equalization program, as a result of Bill C-44, it is clear that much more needs to be done to restore financial health to New Brunswick and some other provinces. The transfer system must be carefully monitored to ensure that the system's shortcomings of the past five years do not persist for another half decade.

APPENDIX I

THE 1987-92 EQUALIZATION FORMULA

APPENDIX 1
THE REPRESENTATIVE TAX SYSTEM AND THE 1987 EQUALIZATION FORMULA

The 1987-92 equalization formula will operate in essentially the same manner as the 1982 program.

The 1987 formula equalizes each province's revenue raising capacity up to a "representative average standard" comprised of the fiscal capacities of British Columbia, Manitoba, Saskatchewan, Quebec and Ontario. This representative standard was first adopted in 1982, prior to which a national standard had been employed.

A province becomes eligible to receive equalization when its per capita fiscal capacity is less than the per capita fiscal capacity of the five provinces in the standard. The 1987 formula equalizes each province's per capita yield for each of 38 revenue sources to the per capita yield of the five provinces in the standard.

The revenue sources subject to equalization in the 1987 formula are listed in the following table.

REVENUES EQUALIZED UNDER THE 1987 FORMULA

1. Personal Income Taxes
2. Business Income Revenues
3. Capital Tax Revenues
4. General and Miscellaneous Sales Taxes*
5. Tobacco Taxes
6. Gasoline Taxes
7. Diesel Fuel Taxes
8. Non-Commercial Vehicle Licenses
9. Commercial Vehicle Licenses
10. Revenues from the Sale of Spirits
11. Revenues from the Sale of Wine
12. Revenues from the Sale of Beer
13. Hospital and Medical Insurance Premiums
14. Race Track Taxes
15. Forestry Revenues
16. New Oil Revenues
17. Norp Oil Revenues
18. Old Oil Revenues
19. Heavy Oil Revenues
20. Mined Oil Revenues
21. Domestically Sold Natural Gas Revenues
22. Exported Natural Gas Revenues
23. Sales of Crown Leases
24. Mineral Resources - Iron
25. Mineral Resources - Uranium
26. Mineral Resources - Asbestos
28. Mineral Resources - Coal*
29. Mineral Resources - Other
30. Potash Revenues*
31. Water Power Rentals
32. Insurance Premium Revenues
33. Payroll Taxes
34. Provincial-Local Property Tax Revenues*
35. Lottery Revenues*
36. Miscellaneous Provincial-Local Taxes and Revenues
37. Shared Revenues: Undistributed Income on Hand
38. Shared Revenues: Off-Shore Activities

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*Technical changes have been made in the tax bases for these revenue sources for the 1987-92 formula. Succession duties and gift taxes, which were equalized in the 1982 formula, have been dropped from the 1987 formula as a separate revenue category since these are no longer important revenue sources. Any revenues raised in this respect will be placed in the miscellaneous category with the 1987 formula.

How Equalization Payments are Determined

Each revenue source has a corresponding tax base, which is commonly defined for all provinces. Fiscal capacity is represented by the per capita yield of these tax bases when national average tax rates are applied. A fiscal deficiency results when a province's per capita yield is less than the corresponding per capita yield of those provinces in the standard. With a fiscal excess, a province's per capita yield would be above that of the standard. The sum of a province's fiscal excesses or deficiencies for 38 revenue sources results in a per capita total, which when multiplied by population gives equalization entitlements for a province.

The total equalization entitlement for a Province in a given year is the sum of the entitlements for the 38 revenue sources subject to equalization. The methodology for determining each province's annual equalization entitlement involves the following:

1) each province's tax base is estimated for each revenue source;

2) a national average tax rate for each revenue source is calculated by dividing the total revenues for all provinces by the sum of the value of the tax bases for all provinces;

3) the yield when a national average tax rate is applied to each province's tax base for each revenue source is determined and expressed in per capita terms;

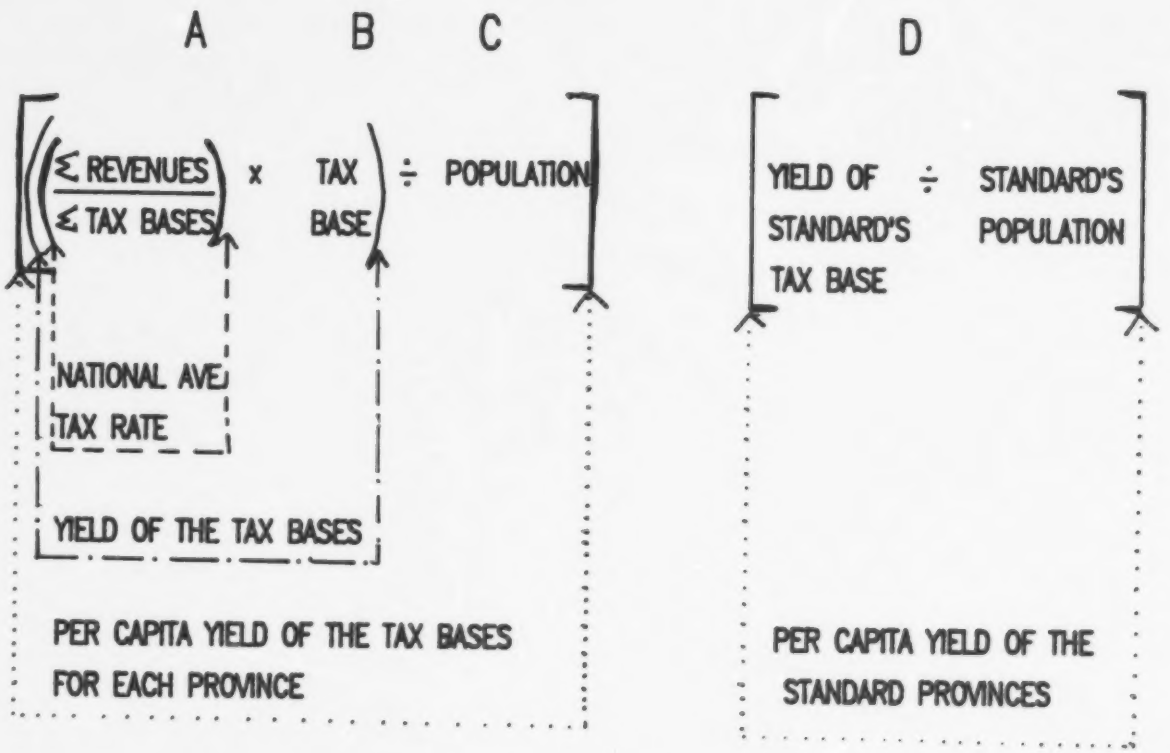
4) the per capita yield of the representative average standard by revenue source is determined by aggregating the results of calculation number 3 for the five provinces making up the standard;

5) the per capita deficiency/excess of each province's yield for each revenue source is determined by subtracting that yield from the per capita yield of the standard;

6) equalization entitlement is obtained by aggregating the results of calculation number 5 and multiplying the result by each province's population.

A schematic representation of this procedure appears in Diagram 1, with a description of each step.

DIAGRAM 1



Description of steps:

A: National Average Tax Rates are calculated from the sum of revenues for 38 sources divided by the sum of their respective tax bases .

B: The National Tax Rates are applied to each province's 38 tax bases to get Yield.

C: The Yield is then expressed in per capita terms.

D: The yield of the tax bases for the provinces in the standard are summed and expressed in per capita terms.

The difference between the Standard's Yield Per Capita,D, and a Province's Yield Per Capita, A,B,&,C, results in an excess (−) or a deficiency (+) for every revenue source. These differences are multiplied by population and summed. If the result is positive, a province will receive Equalization since its yield is less than the Stanadard's.

APPENDIX 2

THE 1986 EPF FORMULA

APPENDIX 2

ESTABLISHED PROGRAMS FINANCING (E.P.F.)

In 1977-78, Established Programs Financing (EPF) replaced three cost shared programs, Hospital Insurance, Medicare and Post-Secondary Education. When EPF block funding was put in place in 1977, annual increases in provincial spending on health care and post-secondary education ceased to play any role in determining annual increases in federal contributions to these programs. Instead, under EPF, yearly increases in federal grants in support of health care and post-secondary education became dependent on the growth in the national economy by means of a GNP escalator.

The initial EPF block fund used the actual national per capita expenditure of the federal government on these three programs in 1975-76 as the base. This funding commitment was to increase each year at the same growth rate as per capita GNP, expressed as a three year moving average. With the latest change in the EPF formula, beginning in 1986-87 the GNP escalator for the total block will be reduced by 2 percent each year. This will reduce the rate of growth of the EPF block fund, which in turn will reduce the growth in EPF cash transfers to the provinces.

How EPF Cash Payments are Determined

The EPF fiscal transfer has two components: a cash payment and a tax transfer, equalized so that one tax point has the same value in all provinces. The tax transfer resulted from a federal tax reduction in 1977-78 equal to 13.5 personal and 1 corporate income tax points. This allowed the provinces the room to raise their taxes in order to help finance their health care and post-secondary education programs.

Annual EPF cash payments to each province are a function of a number of factors. These include gross national product, the value of tax points transferred with the introduction of EPF, as well as associated equalization, and provincial population.

Using New Brunswick as an example and 1987-88 as the year in question, the steps to determine New Brunswick's EPF cash grant for 1987-88 can be summarized as follows:

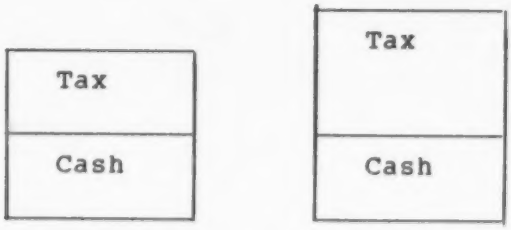
Step 1 Measures of gross national product for 1983 and 1986 are used to calculate the GNE escalator for 1987-88;

Step 2 The GNE escalator for 1987-88 as calculated in Step 1 is reduced by 2 percentage points, and the result is multiplied by the national per capita value of the EPF block of cash and tax points for 1986-87 to determine the national per capita value of the EPF block of cash and tax points for 1987-88;

Step 3 The value of New Brunswick's EPF block of cash and tax points for 1987-88 is determined by multiplying the national per capita value of the EPF block of cash and tax points for 1987-88 as calculated in Step 2 by New Brunswick's population for 1987;

Step 4 EPF cash is essentially a residual. For 1987-88 New Brunswick's EPF cash grant is determined by subtracting the 1987-88 value of the equalized tax points, which were originally transferred to the Province with the introduction of EPF, from the value of New Brunswick's EPF block of cash and tax points for 1987-88 as determined in Step 3.

EPF cash may grow at a different rate than the EPF block of cash and tax points. This is possible because EPF cash is essentially a residual amount after the value of EPF tax points and associated equalization have been determined. This can be illustrated below:



(1) The GNE escalator determines the growth of the EPF cash and tax block fund, i.e., the difference between the size of the block in year 2 compared to year 1.

(2) But the value of the tax transfer in year 2 ultimately determines the value of EPF cash in year 2.

APPENDIX 3

INTERPROVINCIAL COMPARISON OF PROVINCIAL-LOCAL PUBLIC SECTOR EXPENDITURES

CONSOLIDATED PROVINCIAL / LOCAL CURRENT SPENDING ON SERVICES AND BENEFITS
$ PER CAPITA
(EXCLUDING DEBT CHARGES AND ESTIMATED PROVINCIAL/LOCAL CAPITAL SPENDING)

YEAR	NFLD	PRINCE EDWARD ISLAND	NOVA SCOTIA	NEW BRUNSWICK	QUEBEC	ONTARIO	MANITOBA	SASK.	ALBERTA	BRITISH COLUMBIA	NWT AND YUKON	CANADA
1972	753	820	747	771	917	914	844	792	929	850		890
1973	847	980	928	852	1,019	1,034	964	910	1,106	1,063		1,020
1974	1,070	1,186	1,056	998	1,270	1,253	1,206	1,203	1,486	1,343		1,266
1975	1,331	1,454	1,288	1,246	1,529	1,484	1,530	1,467	1,736	1,690		1,526
1976	1,529	1,552	1,423	1,375	1,804	1,659	1,724	1,737	2,158	1,787		1,743
1977	1,502	1,935	1,677	1,446	2,035	1,840	1,978	1,943	2,208	1,933		1,925
1978	2,091	2,017	1,872	1,581	2,307	1,968	1,832	2,042	2,531	2,096		2,114
1979	2,078	1,978	1,931	1,706	2,517	2,078	2,013	2,321	2,928	2,400		2,303
1980	2,324	2,120	2,299	1,966	2,898	2,295	2,363	2,648	3,341	2,807		2,621
1981	2,438	2,489	2,747	2,311	3,281	2,586	2,666	2,981	3,794	3,248		2,980
1982	2,808	2,853	2,804	2,737	3,697	2,932	3,027	3,400	4,889	3,651		3,422
1983	3,109	2,986	3,008	2,885	4,045	3,184	3,484	3,583	5,084	3,819		3,688
1984	2,974	2,971	3,300	3,038	4,066	3,351	3,644	3,770	5,336	3,936		3,816
1985	3,232	2,958	3,341	3,255	4,391	3,720	3,879	3,967	5,853	3,882		4,108
1986	3,476	3,300	3,434	3,441	4,708	3,859	3,975	4,188	5,980	4,049		4,302

CONSOLIDATED PROVINCIAL / LOCAL CURRENT SPENDING ON SERVICES AND BENEFITS
PER CAPITA AS A PERCENT OF CANADA
(EXCLUDING DEBT CHARGES AND ESTIMATED PROVINCIAL/LOCAL CAPITAL SPENDING)

YEAR	NFLD	PRINCE EDWARD ISLAND	NOVA SCOTIA	NEW BRUNSWICK	QUEBEC	ONTARIO	MANITOBA	SASK.	ALBERTA	BRITISH COLUMBIA
1972	84.6	92.1	83.9	86.6	103.0	102.7	94.8	88.9	104.3	95.5
1973	83.0	96.0	91.0	83.5	99.9	101.4	94.5	89.1	108.4	104.2
1974	84.5	93.7	83.4	78.9	100.3	99.0	95.3	95.1	117.4	106.1
1975	87.2	95.3	84.4	81.6	100.2	97.2	100.3	96.2	113.8	110.8
1976	87.7	89.1	81.7	78.9	103.5	95.2	98.9	99.6	123.8	102.5
1977	78.0	100.5	87.1	75.1	105.7	95.6	102.7	100.9	114.7	100.4
1978	98.9	95.4	88.6	74.8	109.1	93.1	86.6	96.6	119.7	99.2
1979	90.2	85.9	83.8	74.1	109.3	90.2	87.4	100.8	127.2	104.2
1980	88.7	80.9	87.7	75.0	110.5	87.5	90.1	101.0	127.4	107.1
1981	81.8	83.5	92.2	77.6	110.1	86.8	89.5	100.0	127.3	109.0
1982	82.1	83.4	81.9	80.0	108.0	85.7	88.5	99.4	142.9	106.7
1983	84.3	80.9	81.5	78.2	109.7	86.3	94.5	97.1	137.8	103.5
1984	77.9	77.9	86.5	79.6	106.6	87.8	95.5	98.8	139.8	103.2
1985	78.7	72.0	81.3	79.2	106.9	90.5	94.4	96.6	142.5	94.5
1986	80.8	76.7	79.8	80.0	109.4	89.7	92.4	97.3	139.0	94.1

CONSOLIDATED PROVINCIAL / LOCAL GROSS GENERAL EXPENDITURE
$PER CAPITA
(INCLUDES CAPITAL SPENDING AND DEBT SERVICE)

YEAR	NFLD	PRINCE EDWARD ISLAND	NOVA SCOTIA	NEW BRUNSWICK	QUEBEC	ONTARIO	MANITOBA	SASK.	ALBERTA	BRITISH COLUMBIA	NWT AND YUKON	CANADA
1966	577	506	451	446	521	558	493	594	664	530	508	544
1967	641	560	544	553	623	642	545	646	737	607	680	629
1968	666	579	621	600	672	748	614	698	821	678	791	704
1969	673	706	716	637	749	843	715	740	927	796	1,457	793
1970	796	868	804	825	902	981	846	806	1,057	867	2,036	926
1971	1,117	1,008	888	875	1,061	1,096	958	894	1,163	978	2,359	1,053
1972	1,069	1,079	987	987	1,180	1,168	1,075	1,012	1,205	1,092	2,859	1,145
1973	1,215	1,310	1,191	1,126	1,312	1,301	1,203	1,129	1,385	1,312	3,117	1,294
1974	1,537	1,495	1,379	1,397	1,582	1,564	1,480	1,498	1,856	1,645	3,571	1,587
1975	1,908	1,875	1,653	1,684	1,899	1,832	1,837	1,835	2,221	2,015	3,936	1,898
1976	2,089	1,871	1,773	1,848	2,213	2,020	2,095	2,153	2,636	2,171	4,602	2,141
1977	2,102	2,321	2,043	1,960	2,498	2,229	2,387	2,437	2,778	2,361	5,379	2,368
1978	2,757	2,530	2,310	2,125	2,802	2,392	2,325	2,603	3,179	2,569	6,097	2,602
1979	2,859	2,637	2,424	2,308	3,041	2,540	2,604	3,023	3,700	2,900	6,827	2,844
1980	3,101	2,880	2,804	2,601	3,544	2,798	3,006	3,366	4,266	3,350	7,037	3,233
1981	3,211	3,167	3,430	2,995	3,992	3,131	3,401	3,835	5,086	3,862	8,132	3,683
1982	3,754	3,613	3,590	3,607	4,488	3,570	3,874	4,388	6,579	4,304	8,852	4,244
1983	4,156	3,636	3,852	3,795	4,841	3,860	4,473	4,682	6,483	4,564	10,324	4,524
1984	4,101	3,799	4,184	4,079	4,951	4,107	4,702	4,864	6,640	4,691	11,451	4,707
1985	4,512	3,925	4,338	4,318	5,349	4,525	4,922	5,304	7,252	4,755	12,888	5,075
1986	4,821	4,349	4,560	4,501	5,709	4,692	5,255	5,583	7,436	4,958	14,012	5,319

NOTE: CANADA TOTAL INCLUDES THE YUKON AND NWT.

CONSOLIDATED PROVINCIAL / LOCAL GROSS GENERAL EXPENDITURE PER CAPITA
AS A PERCENT OF CANADA
(INCLUDES CAPITAL SPENDING AND DEBT CHARGES)

YEAR	NFLD	PRINCE EDWARD ISLAND	NOVA SCOTIA	NEW BRUNSWICK	QUEBEC	ONTARIO	MANITOBA	SASK.	ALBERTA	BRITISH COLUMBIA	NWT AND YUKON
1966	106.2	93.1	82.9	82.1	95.9	102.6	90.7	109.3	122.2	97.5	93.5
1967	101.9	89.0	86.5	87.9	99.1	102.0	86.7	102.7	117.2	96.5	108.0
1968	94.5	82.2	88.1	85.2	95.4	106.3	87.2	99.2	116.5	96.2	112.3
1969	84.8	89.1	90.3	80.3	94.5	106.3	90.1	93.3	116.9	100.3	183.8
1970	86.0	93.8	86.9	89.2	97.5	106.0	91.4	87.1	114.3	93.6	220.0
1971	106.0	95.7	84.3	83.0	100.8	104.0	90.9	84.9	110.4	92.8	224.0
1972	93.4	94.2	86.2	86.2	103.0	102.0	93.9	88.4	105.2	95.4	249.6
1973	93.9	101.2	92.1	87.0	101.4	100.5	93.0	87.3	107.1	101.4	240.9
1974	96.9	94.2	86.9	88.1	99.7	98.6	93.3	94.4	117.0	103.7	225.1
1975	100.5	98.8	87.1	88.7	100.0	96.6	96.8	96.7	117.0	106.2	207.4
1976	97.6	87.4	82.8	86.3	103.4	94.4	97.9	100.6	123.2	101.4	215.0
1977	88.8	98.0	86.3	82.8	105.5	94.1	100.8	102.9	117.3	99.7	227.2
1978	106.0	97.2	88.8	81.7	107.7	91.9	89.4	100.0	122.2	98.7	234.3
1979	100.5	92.7	85.2	81.2	106.9	89.3	91.5	106.3	130.1	101.9	240.0
1980	95.9	89.1	86.7	80.4	109.6	86.5	93.0	104.1	131.9	103.6	217.6
1981	87.2	86.0	93.1	81.3	108.4	85.0	92.3	104.1	138.1	104.9	220.8
1982	88.5	85.1	84.6	85.0	105.7	84.1	91.3	103.4	155.0	101.4	208.6
1983	91.9	80.4	85.1	83.9	107.0	85.3	98.9	103.5	143.3	100.9	228.2
1984	87.1	80.7	88.9	86.7	105.2	87.3	99.9	103.3	141.1	99.7	243.3
1985	88.9	77.3	85.5	85.1	105.4	89.2	97.0	104.5	142.9	93.7	253.9
1986	90.6	81.8	85.7	84.6	107.3	88.2	98.8	105.0	139.8	93.2	263.4

APPENDIX 4
LETTER FROM HONOURABLE MICHAEL WILSON CONCERNING SUPPLEMENTARY EQUALIZATION PAYMENTS

Minister of Finance | Ministre des Finances

CANADA

MAY 28 1985

The Honourable John B.M. Baxter, Q.C., M.L.A.
Minister of Finance
Province of New Brunswick
Centennial Building
P.O. Box 6000
Fredericton, New Brunswick
E3B 5H1

Dear ~~Minister~~ John:

I am replying to two letters which you wrote to me on February 12, 1985. These concerned the difficult fiscal position of New Brunswick, and certain matters relating to your Tax Collection Agreement with the federal government.

Your letter on the fiscal position of New Brunswick focussed on federal transfers to the Province and, in particular, on equalization. With regard to equalization, I have as you know tabled a Bill which provides for a Supplementary Equalization payment of $20 million to New Brunswick. The concern which you expressed in your letter about New Brunswick's situation, and which you subsequently raised with me when we met on March 21, was a major factor in my decision to extend the supplementary payments to all six provinces which receive equalization.

Certainly we have done our best to recognize the particular circumstances in which New Brunswick finds itself, and to arrive at a system of supplementary equalization payments which would be as fair as possible to all provinces. I do not need to tell you that this decision was not easy for me given the very difficult financial circumstances of the federal government and the fact that we were under no obligation to provide additional assistance. I would hope that you will agree that the solution is a fair and reasonable one in the circumstances.

You had suggested that one means of dealing with this problem would be to enrich the equalization program by means of a new measure of fiscal capacity for property taxes, and I would like now to reply to you on that particular point. While this

.../2

Ottawa, Canada K1A 0G5

approach did not commend itself as a way of dealing with the more general problem with which we were recently faced, I can tell you that the possibility of making changes to the tax base used to equalize revenues from property taxes is something to which I am prepared to give careful consideration. However, as this involves changes of a fairly basic, structural nature, I believe it would most appropriately be considered in the context of the upcoming review of the Equalization Program for 1987 where the kind of detailed examination required can be given.

With regard to payments under the Tax Collection Agreements, I would like to thank you for your appreciation and acceptance of my offer to extend the recovery period occasioned by the lower than anticipated payments through March. As you know, I have since written to you to put into effect the necessary amendments to the Agreement.

In the meantime I have also taken note of the concern reflected in your letter about the implications of lower tax revenue forecasts for your fiscal planning. As you will readily recognize, this is a problem which the federal government very much shares and which we are looking into very carefully with a view to determining the underlying factors involved. When this work is completed I would be more than pleased to share the results with you, and I believe that my officials have been in touch with yours in this regard.

Yours sincerely,

Mike

Michael H. Wilson

APPENDIX 5

NEW BRUNSWICK'S BRIEF TO
THE PARLIAMENTARY COMMITTEE
REVIEWING BILL C-96

BRIEF TO THE PARLIAMENTARY COMMITTEE ON BILL C - 96

JUNE 1986

PROVINCE OF NEW BRUNSWICK

INTRODUCTION

The Government of New Brunswick is deeply concerned about Bill C-96. The Government has chosen to prepare this brief to place its views about Bill C-96, and federal-provincial fiscal arrangements in general, before this Committee, and through it, before the Parliament of Canada.

Appended to this Brief is a copy of a resolution unanimously passed by the New Brunswick Legislative Assembly concerning federal reductions in the rate of growth in transfers to provinces.

IMPACT OF BILL C-96 ON NEW BRUNSWICK

Equalization payments and EPF are of critical importance to New Brunswick. For 1986-87 equalization and EPF will contribute $944 million to New Brunswick revenues. Together these federal transfer payments provide over one-third of the Province's annual revenue. They produce more revenue than the Province raises from its personal income tax and the sales tax combined.

Because equalization and EPF play such an important role in New Brunswick's financial picture, any change in either of these programs is significant. For this reason New Brunswick is deeply disturbed about Bill C-96, which will result in much lower EPF payments, and which will become effective a year before negotiations with respect to the equalization program for the period 1987-92 have been finalized.

When EPF was put in place in 1977, annual increases in provincial spending on health care and post-secondary education ceased to play any role in determining annual increases in federal contributions to these programs. Instead, under EPF, yearly increases in federal grants in support of health care and post-secondary education became dependent on the growth in the national economy by means of a GNP escalator.

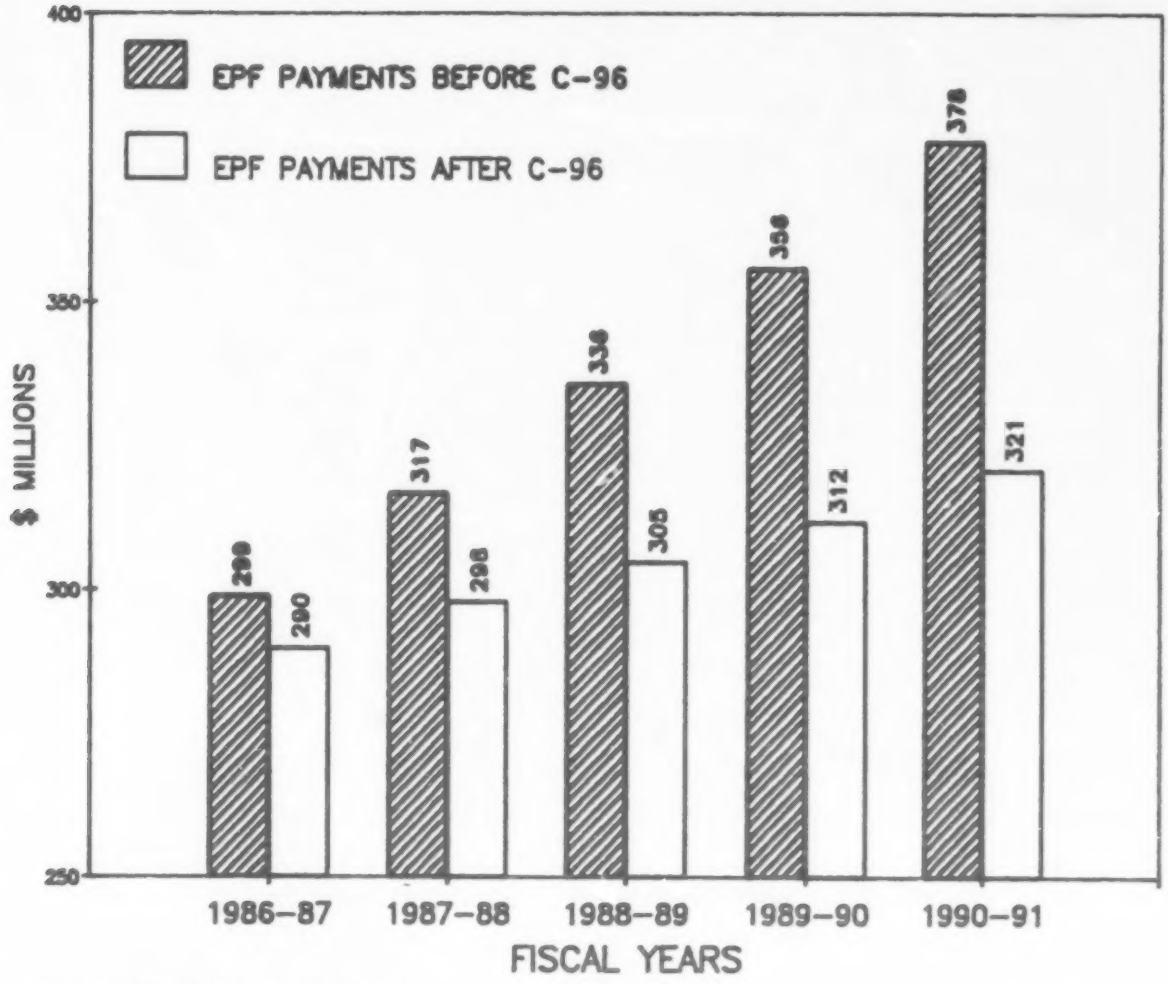
With Bill C-96, the GNP escalator will continue to play an important role in determining annual increases in EPF, but the escalator will be reduced by two percentage points from what it would have otherwise been each year. New Brunswick's finances will be seriously affected by this change. Chart I below compares the amount of revenue New Brunswick will receive under the new EPF formula with the revenue it would have received had the old formula been retained.

Table I illustrates the magnitude of the revenue loss to New Brunswick as a consequence of Bill C-96, over the next five years. This table shows that while the impact in 1986-87 is relatively small, i.e., a $9 million reduction from what the province would have received if the EPF formula not been changed, the losses increase each year, totalling $160 million over a five year period.

TABLE I
NEW BRUNSWICK'S ANNUAL REVENUE LOSSES
AS A RESULT OF BILL C-96

	$Millions
1986-87	9.0
1987-88	19.0
1988-89	31.0
1989-90	44.0
1990-91	57.0
Total	160.0

CHART I
PROJECTIONS OF E.P.F. CASH
NEW BRUNSWICK



SOURCE:FEDERAL DEPARTMENT OF FINANCE

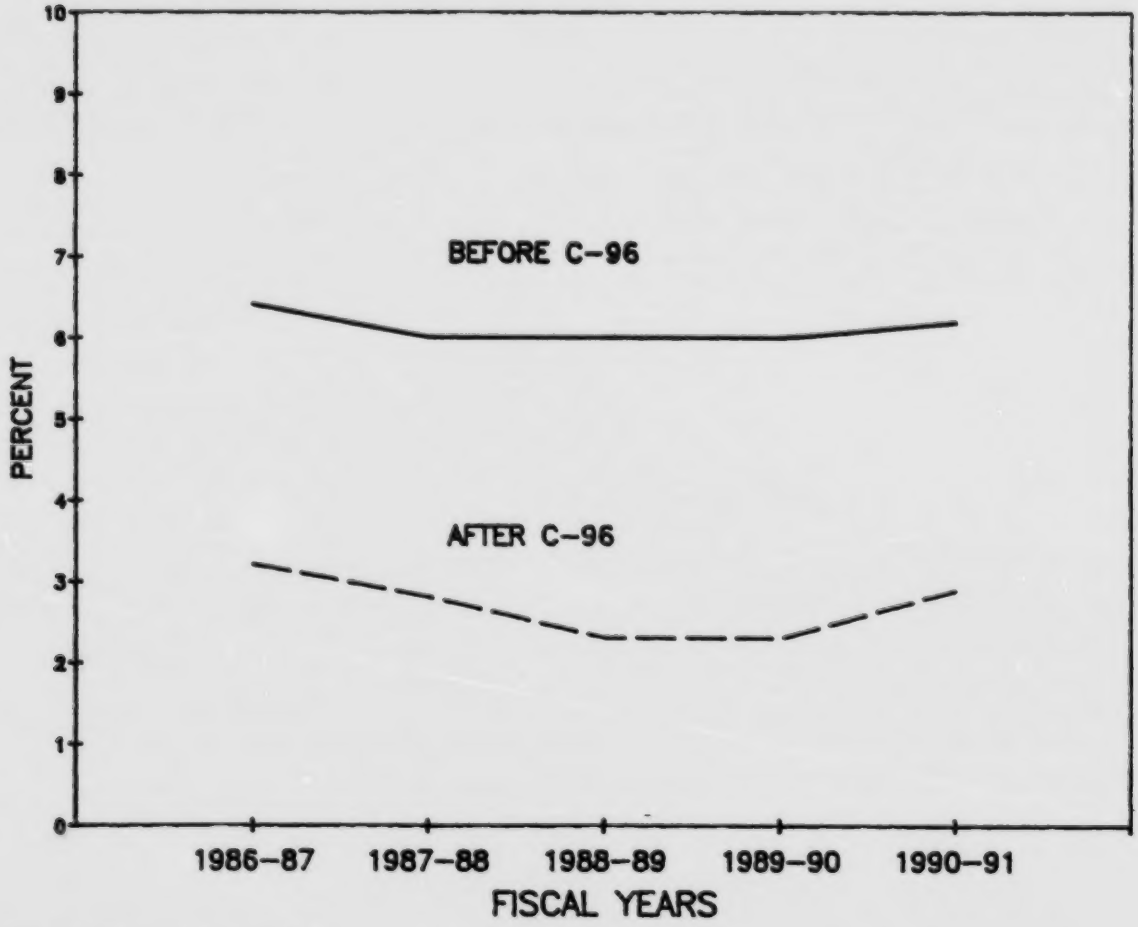
The revenue losses as a result of Bill C-96 will also significantly reduce the growth rate in EPF payments to New Brunswick. This is clearly shown in Chart II below.

There are a number of important conclusions that can be drawn from Chart II. First, while EPF payments will continue to grow with Bill C-96, growth will be much lower under the new EPF formula than would have been the case had the formula not been changed. Of even more significance, however, rates of growth with the new formula will be much less than the anticipated increase in the costs of those very health care and post-secondary education programs EPF was designed to help finance. In fact, under the new EPF formula, payments for 1986-87 and 1987-88 will grow by less than the inflation rate assumed in the recent federal budget.

It is always difficult for provinces to cope with reductions in revenue. Bill C-96 is particularly difficult for smaller provinces because it adds to the cumulative effect of previous measures which have been adopted to reduce federal financial commitments to post-secondary education and health care.

These measures go back to the early seventies. Beginning in 1972, the federal government began to take steps to reduce its financial commitments to the provinces for these important programs when it placed a cap on its contributions for post-secondary education. This was followed by a ceiling which was placed on federal medicare contributions in 1975.

CHART II
COMPARISON OF EPF CASH GROWTH RATES
NEW BRUNSWICK



SOURCE :N.B. DEPT. OF FINANCE

The introduction of caps and ceilings was contrary to the original intent of these agreements. The result was that by the early seventies the federal government was only prepared to match provincial spending up to a specified level beyond which the provinces were left with responsibility to finance these programs from their own resources.

The 1977 fiscal arrangements replaced federal conditional grants to the provinces in support of medicare, hospital services and post-secondary education with a new program, Established Programs Financing. Under this program a single cash grant and a transfer of personal and corporate tax points replaced cost-sharing arrangements under which the federal government helped finance medicare, hospital services and post-secondary education.

The EPF arrangement was a compromise. One of the key features of EPF was that it was designed to produce long term certainty for both the federal and provincial governments. The federal government obtained certainty that no matter how much the provinces spent on these programs its contributions would not exceed the growth in the national economy. The provinces obtained certainty that the federal government would refrain from applying arbitrary caps and limits to its contributions, and so could plan accordingly.

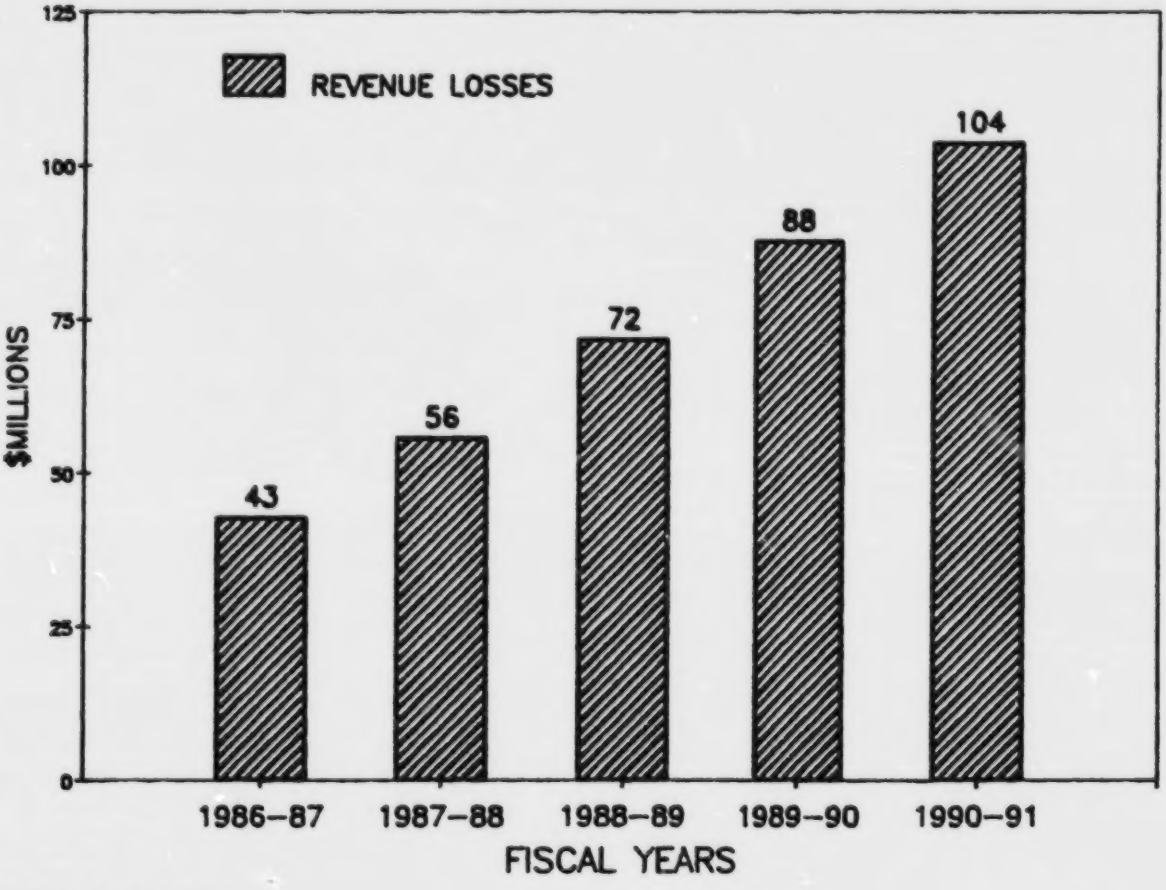
Yet, less than two years after it convinced the provinces to accept the EPF arrangement, the federal government wanted to change its terms and thereby reduce EPF payments to provinces. On this occasion the provinces successfully resisted cuts to EPF, but the federal government responded by cutting other transfer programs.

In the 1981 federal budget the Government of Canada announced that it planned to change the EPF formula in order to save over $5 billion in the period 1982 to 1987. This change was made in 1982, contrary to the recommendations of all the provinces, the Economic Council of Canada and an all party Parliamentary Task Force. Within a year, another change was announced and legislation was enacted whereby EPF contributions were arbitrarily capped insofar as post-secondary education was concerned in 1983 and 1984.

This continuing pattern of attrition has imposed considerable costs on New Brunswick. Bill C-96 will add significantly to those costs. While it is difficult to measure the total cost of federal retrenchment back to 1972 because of technical problems associated with making comparisons in a pre and post-EPF regime, estimates can be made of the costs of those changes which have been made to the original EPF program. These are shown in Chart III.

Chart III reveals the full effect of reduced federal assistance to New Brunswick's health care and post-secondary education programs in the years ahead. This chart shows for example that for 1986-87 New Brunswick will be receiving about $43 million less from the federal government for health and post-secondary education than it would have received if no changes had been made to the original EPF formula. By 1990, New Brunswick will have to absorb revenue losses exceeding $100 million each year.

CHART III
ANNUAL REVENUE LOSSES AS A RESULT OF CHANGES TO THE ORIGINAL E.P.F. PROGRAM
NEW BRUNSWICK



SOURCE:N.B.DEPT. OF FINANCE

New Brunswick has contended with a difficult fiscal situation since 1982-83. In part, the Province's recent fiscal problems have been the result of changes in the EPF formula in 1982 and 1983. The Province's fiscal position was made worse by an equalization program which did not produce the revenue originally predicted by the former federal government. As a result federal transfer payments, which covered about 47 percent of New Brunswick's ordinary account spending throughout the period 1972 to 1982, accounted for only about 41 percent of this spending in 1985-86.

Reduced federal support for provincial spending added seriously to the financial and economic strains of the 1982 recession. The recession contributed to deficits all across Canada and resulted in a significant increase in government debt. Generally speaking the deterioration in New Brunswick's finances that began in the early 1980's has been halted and its ordinary account deficit has been brought under control. However, debt levels are now much higher and the percentage of spending that must be allocated to paying interest on debt is well above pre-recession levels.

The economic recovery from the recession has been stronger in Central Canada where non-resource based manufacturing has done well, and weaker in regions of the country with resource based economies. Similarly the underlying fiscal health of some parts of the country has improved more rapidly than others.

Looking beyond the financial data, it is apparent that there have been fundamental shifts in New Brunswick's situation relative to other provinces. On the spending side of the ledger, New Brunswick's total provincial-local spending on a per capita basis was only 83.9% of the Canadian average in 1985-86. In 1982-83 it was 84.6% of the average for all Canada and in 1970-71 it was 89%. It should be noted moreover that aggregate spending statistics include interest payments on debt which do not represent current services to people. If interest costs are deleted from interprovincial comparisons of spending in order to give a clearer picture of actual spending on services, New Brunswick falls to 81.3% of the Canadian average in 1985-86 an even sharper decline from the level of 83.4% that existed in 1982-83 and 89.4% in 1970-71.

The inescapable conclusion from this data is that the Province of New Brunswick is being forced to restrain spending to a greater extent than the country as a whole, and that the historical spending gap between this province and the average for all of Canada is widening. The widening has been significant since 1982-83 with the combined impact of the recession and reduced federal transfers.

The Government of New Brunswick has managed to sustain basic levels of service in spite of reduced overall spending in comparison to the Canadian averages. This has been achieved in three ways: (a) keeping wage and salary growth to a minimum by asking public sector employees to accept pay increases well below the inflation rate in order that service levels and employment can be sustained; (b) by concentrating on efficiency in delivery of services through such measures as integrating departments; (c) by virtually freezing the range of services that is offered by the provincial government. It should be noted for example, that in New Brunswick there is no government kindergarten, or provincial income supplement to low income senior citizens. It should also be noted that in the health field, the federal government abandoned cost-sharing before New Brunswick's health programs had matured, and provincial service levels in this field remain substantially below the norm for all provinces.

The Government has not confined its restraint measures to the spending side of the ledger. Since 1982-83 New Brunswick has increased taxes in most fields. The Province's tax burden, that is, total tax revenue as a percentage of provincial gross domestic product, has increased by 16% since 1982-83, while the average increase for all provinces over the same period was less than one percent.

New Brunswick now has very limited capacity left to raise additional revenue through higher taxes. The Province's private sector relies heavily on exports of resource based products. Unlike some industries in other parts of the country, New Brunswick industry cannot simply increase prices when faced with higher taxes. In short, higher taxes are likely to be borne totally by industry in New Brunswick, not by consumers elsewhere.

The tax question is of great concern to the Province of New Brunswick and a review of our total tax structure is now underway.

The Government of New Brunswick is justifiably proud of its achievements in virtually balancing the ordinary account and halting the growth in the share of provincial revenues going to pay interest costs. These results were achieved with great difficulty and required political courage and determination.

New Brunswick's improved financial situation puts the Province in a good position to encourage new investment and growth. That growth in the provincial economy is needed to generate the tax revenue required to ease the strict expenditure restraint that the Government has been operating under. That growth is needed to ease the tax burden borne by New Brunswick's economy. The fact of the matter is that New Brunswick cannot sustain restraint indefinitely in the face of improving levels of service and higher wages and salaries in other jurisdictions.

The Government's challenge is to find the means to ease a restraint regime that will become increasingly difficult to sustain. The urgent task for New Brunswick is to find new revenue, not to determine how to live with less.

This Brief has outlined the essential elements of New Brunswick's fiscal situation: a declining level of spending relative to other provinces and increasing levels of taxes. If the federal transfer system were working properly, this would not occur; one province's fiscal situation should not worsen significantly in relation to the others. That this has occurred underlines the shortcomings of the equalization program. According to Canada's Constitution "Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

CONCLUSION

The provisions of Bill C-96 pose an ominous threat to New Brunswick's whole fiscal system and threaten to undo the Government's accomplishments in restoring provincial finances. If the equalization program had been working as envisaged in the Constitution New Brunswick would not have such a serious problem with Bill C-96. The fact that the Government has been obliged in recent years to reduce New Brunswick's relative level of spending and increase the Province's relative level of taxes points out a defect in equalization. As a result the provisions of Bill C-96 will not fall equally on provinces because provinces already vary significantly in their fiscal circumstances.

Canada's national deficit and debt are very serious matters. New Brunswick has made this observation on many occasions - indeed New Brunswick did so even before it was a concern at the federal level. The Government of New Brunswick also said that these problems must be dealt with in a fair and equitable manner. The burden of dealing with public sector deficits should be shared fairly among all Canadians.

That is not the way the situation is working in practice. Members of this Committee must look to the fiscal circumstances of the various provinces that are being asked to absorb the federal economy measures contained in Bill C-96 and ask if these are being distributed fairly among Canadian taxpayers. You will find that they are not.

Federal restraint measures may well force New Brunswick into increased deficits and debt. This will mean that the federal government with its AAA credit rating will be shifting a portion of its borrowing requirement to New Brunswick, a single A credit with limited access to borrowed funds. For Canadian taxpayers living in New Brunswick the result will be higher interest costs than if the federal government had incurred the debt.

The injustice of Bill C-96 is driven home by New Brunswick's accomplishments in dealing with its own fiscal problem. If the Government of Canada had done the same several years ago when its fiscal problems first became evident, today's Government of Canada would not be asking the people of New Brunswick to sacrifice more programs and borrow more.

APPENDIX
MOTION 4 BY MR. MCKENNA
AS AMENDED BY HONOURABLE J.B.M. BAXTER, Q.C.

WHEREAS the Government of Canada has announced that the rate of growth in transfer payments under the Established Programs Financing Act will be decreased commencing in 1986; and
WHEREAS this reduction in the rate of growth will cost New Brunswick $9 million this year and will total an estimated $160 million by 1990-91; and

WHEREAS New Brunswick does not have the economic base to absorb such a loss;

BE IT THEREFORE RESOLVED that the Legislative Assembly of New Brunswick requests the Government of Canada to reconsider its unilateral decision and restore the Established Programs Financing to the level agreed to in 1982; and

BE IT FURTHER RESOLVED that the Legislative Assembly of New Brunswick request the Government of Canada to enter into discussions with the Provinces in an effort to mutually agree to the level of funding under the Established Programs Financing Act for 1987-88 and beyond; and

BE IT FURTHER RESOLVED that should any reduction in the rate of growth of funding under the Established Programs Financing Act be agreed to that the federal government take steps through the equalization program to compensate the Atlantic Provinces for such EPF losses, and ensure that the equalization program provide sufficient revenues so that all provinces have the ability to provide comparable levels of public services at comparable levels of taxation.

APPENDIX 6

SELECTION OF TECHNICAL PAPERS CONCERNING THE EQUALIZATION FORMULA TABLED BY NEW BRUNSWICK AUGUST 1985 TO OCTOBER 1986

THE PROPERTY TAX BASE IN THE EQUALIZATION FORMULA: A CRITIQUE AND A PROPOSAL FOR CHANGE

Department of Finance
Province of New Brunswick
August 1985

General

The Province of New Brunswick has a structural deficit which it has been unable to eliminate, despite major tax increases and expenditure reductions.

New Brunswick's deficit does not arise because of excessive spending. Government expenditures in New Brunswick have been, and continue to be among the lowest in Canada. Moreover, the Province's deficit is not the result of a low tax effort. In fact, the degree to which New Brunswick exploits its own tax base is among the highest in Canada.

New Brunswick's deficit persists in large part because the current federal transfer system does not provide adequate funds. In particular, the equalization program is not meeting its objectives.

There are a number of areas that could be looked into to explain why equalization payments to New Brunswick are not sufficient. The Government of New Brunswick believes that one area where the equalization formula is deficient is in the definition of the property tax base. As a consequence the Province is not receiving the equalization that should reasonably be expected, given the objectives of the equalization program.

The purpose of this paper is to outline New Brunswick's concerns about the property tax base, and to describe its proposal to improve the current tax base and the equalization program.

Background

Property taxes have been equalized in one form or other since 1967-68. Originally, only property taxes levied by provincial governments were brought into the equalization formula. In 1973-74 local property taxes for school purposes became eligible for equalization, and in 1982-83 property taxes levied by local governments for municipal purposes entered the program. The result is that since 1982-83 all provincial and municipal property taxes have been equalized.

When property taxes were first brought into the equalization program they played a relatively small role in determining provincial entitlements. Indeed, previous to 1973-74 property taxes were placed in the miscellaneous revenue category of the equalization formula used at that time.

This contrasts sharply with current circumstances. Table 1 below compares the significance of property taxes for equalization entitlements in 1977-78, the first year of the last five year period when a national average standard was used, and for 1982-83, the first year they were equalized in full with the current five province standard.

TABLE 1

ANNUAL EQUALIZATION ENTITLEMENTS FOR PROPERTY TAXES IN $MILLIONS AND AS A PERCENT OF TOTAL ENTITLEMENTS

Province	1977-78 ($M)	1977-78 (%)	1982-83 ($M)	1982-83 (%)
Newfoundland	27.3	9.8	88.3	19.2
Prince Edward Island	5.5	8.7	17.7	15.9
Nova Scotia	30.2	8.8	103.8	21.5
New Brunswick	26.1	9.5	85.0	19.1
Quebec	89.0	6.7	370.9	15.5
Manitoba	4.5	1.9	15.7	5.8
Saskatchewan	0.5	0.8	--	--
TOTAL	183.1	7.1	681.4	16.4

In 1977-78 property tax equalization was equal to 7 percent of total equalization entitlements. Of 29 revenue sources they were ranked seventh in importance insofar as total equalization was concerned. With the changes which were made in 1982-83 as a result of the quinquennial review of the equalization formula, property taxes have become the second most important revenue source in terms of total equalization payments. Equalization associated with property taxes is now equal to 16 percent of total equalization entitlements. Only the personal income tax is more important.

The Property Tax Base

To maintain the credibility of the equalization program, it has always been considered essential that the means by which equalization is determined be conceptually and statistically sound. Because the property tax now plays such an important role in establishing each province's equalization entitlement, this is particularly important insofar as the equalization associated with the property tax is concerned.

The key element in determining the distribution of equalization entitlements among provinces is the tax base associated with each revenue source. In most cases tax bases used in the equalization formula are relatively straightforward. They tend to represent what the provinces have available to tax; for example the corporate income tax base is corporate taxable income, the personal income tax base is federal basic tax. When the fiscal capacity associated with a tax base is below the standard for equalization a payment is made to make up the difference.

The provinces and municipalities base their property taxes on "assessed value". Assessed value, in most cases, is meant to reflect market value, although the means of establishing assessed value vary from province to province and in some cases within provinces. The consequence is that there is no comparable inter-provincial property tax base which can be used to determine equalization payments.

In the case of property taxes, the equalization formula has had to rely on a proxy tax base, i.e., a tax base which can be considered a proxy for the actual property tax bases of the provinces. Development of a proxy tax base has proven to be difficult and contentious. Indeed, it is probably safe to say that this has been one of the most difficult aspects of the formula in which to get a strong federal-provincial concensus.

The current property tax base consists of weighted building and land components. The building component consists of the depreciated real value of building structures. Machinery and equipment for the most part are not included. This measure is considered to be a proxy for the assessed value of buildings. The land component consists of real net provincial income at factor cost adjusted for federal transfers and tax withdrawals. This measure is deemed to be a proxy for the assessed value of land. When taken together, these two measures become the proxy property tax base in the equalization formula.

New Brunswick's Criticisms of the Property Tax Base

The Province of New Brunswick is convinced that the current proxy tax base does not reflect the actual tax base on which property taxes are levied in Canada. The Province is unaware of any jurisdiction in Canada which establishes assessed value using a method similar to the way in which the proxy tax base is constructed. For example, there are no provinces which base their assessments on real or deflated values. Similarly provinces give some weight to machinery and equipment in establishing property tax assessments.

It is also New Brunswick's view that the current property tax base does not conceptually represent a good proxy for the assessed value or market value of property. For one thing the current approach does not properly account for the wide variations in land values across the country, especially in large metropolitan areas. In addition the current approach ignores the type and amount of machinery and equipment within the stock of buildings that are in the proxy base. The income producing potential of machinery and equipment as well as the real value of building structures ultimately establishes the assessed value of many properties in the provinces.

New Brunswick contends that the statistical construction of the existing property tax base tends to make poorer rural provinces seem less poor and richer urbanized provinces seem less rich. As far as New Brunswick is concerned the existing property tax base statistically overstates its fiscal capacity with respect to property taxes. The result is that New Brunswick and other recipient provinces are being deprived of considerable equalization entitlements with respect to this revenue source.

The Basis for New Brunswick's Concerns

The current equalization program attributes 2.1 percent of the national property tax base to New Brunswick. At first glance this share of the national tax base may not seem to be unreasonable, but its validity is difficult to accept given the nature of the New Brunswick economy.

Even if one were to look no further, it does not seem logical that a province whose economic indicators are consistently and significantly below the national average, could have a share of the property tax base substantially higher than its share of the land area. New Brunswick is convinced that the only explanation is that the property tax base is out of step with economic reality.

In this regard consider the following table which provides estimates of fiscal capacity for a number of revenue sources.

TABLE 2

NEW BRUNSWICK'S FISCAL CAPACITY FOR SELECTED TAX BASES

1984-85 (THIRD ESTIMATE)

	National Average = 100
Personal Income Tax	65
Corporate Income Tax	44
Capital Tax	55
All Taxes	66
Property Taxes	74

It does not seem reasonable that New Brunswick's fiscal capacity for property taxes is significantly above the average of all taxes, and in particular, income and capital taxes. Yet, from Table 2, that is what the current proxy tax base indicates. It is difficult not to conclude that New Brunswick's fiscal capacity for property taxes is over-stated.

The information in Table 3 further illustrates the inconsistency of the property tax base. This table shows average land values per square kilometer for each Province. These implied land values were determined by dividing the value of the land element in the current property tax base by the land area of each province. The Territories were excluded and fresh water was netted out of the land area. Provincial land values are from the 1982-83 final estimate and land areas are from the Canada Year Book.

TABLE 3

LAND VALUE PER SQUARE KILOMETER

IMPLIED BY PROXY PROPERTY TAX BASE

	($)/KM
Newfoundland	3,101
Prince Edward Island	44,582
Nova Scotia	37,106
New Brunswick	22,384
Quebec	13,273
Ontario	32,571
Manitoba	5,546
Saskatchewan	5,640
Alberta	15,639
British Columbia	10,150
Canada	14,407

This table clearly demonstrates the inadequacy of the existing property tax base. It shows for example that if the current property tax base is correct, some of Canada's most valuable land is in the Maritime Provinces. In New Brunswick's case, its land is the fourth most valuable in Canada, almost 1.6 times as valuable as the national average. When unproductive land is removed from the land base, New Brunswick's land remains considerably more valuable than the national average.

Given the nature of New Brunswick's economy, this makes little sense. If the implied values of land in Table 3 are correct it must be the result of the quality of New Brunswick land. This however, is difficult to accept. First, New Brunswick has limited high density land, it has no class 1 agricultural land, and its forest land, while used intensively, is at best of average quality.

If the high implied value of New Brunswick's land cannot be explained by the land itself it must be as a consequence of the Province's overall economic performance or the income producing potential of its capital stock. It is difficult to conclude that New Brunswick's economy is responsible. New Brunswick's Gross Domestic Product per capita has consistently been below the national average and output per worker has always been lower.

If the economy in general and the land in particular cannot explain why New Brunswick's land should be so valuable the only remaining possibility is the efficiency of the Province's capital stock.

Table 4 contains provincial estimates of Gross Domestic Product in relation to the value of gross capital stock in each province.

TABLE 4

GROSS DOMESTIC PRODUCT PER DOLLAR OF CAPITAL STOCK

($)

	GDP/ Capital Stock
Newfoundland	.19
Prince Edward Island	.26
Nova Scotia	.25
New Brunswick	.20
Quebec	.30
Ontario	.34
Manitoba	.26
Saskatchewan	.24
Alberta	.30
British Columbia	.27
Canada	.30

The information in Table 4 shows that New Brunswick's output relative to the value of its capital stock is substantially below the nation as a whole. This indicates that the income earning potential of New Brunswick's capital stock is much lower than the Canadian average. If, as some would suggest, land values reflect the capitalized value of income potential, the information in this table also cannot explain why the value of land as implied by the property tax base is so high.

The only conclusion that New Brunswick can reach, given the information above, is that the land value and the capital stock estimates in the property tax base cannot be a true reflection of New Brunswick's fiscal capacity to collect property taxes. On the contrary, New Brunswick believes that the property tax base significantly over-states its fiscal capacity with the result that the province loses considerable equalization.

New Brunswick's Proposal

Because the property tax is so important insofar as total equalization is concerned, the property tax base should be improved. Unlike the current proxy tax base, a tax base must be constructed which will not over-state the fiscal capacity of those provinces that depend a great deal on equalization payments.

In this regard New Brunswick has proposed a new tax base for property taxes. In specific terms it has proposed that the existing property tax base be replaced with a new proxy tax base consisting of a weighted personal income, corporate income and paid-up capital tax base.

This proposal is by no means new; a similar proxy tax base for property taxes was used in the equalization program up to 1977. Ultimately, the ability of property owners to pay property tax is determined by their income. Thus in this proposal a proxy property tax base could be constructed by aggregating the yields from the existing personal and corporate income tax bases along with the paid-up capital tax base. The latter component gives some weight to the fact that corporations pay property taxes even if they do not earn taxable income.

Table 5 shows the financial impact of New Brunswick's proposal. While New Brunswick's proposal would also have some impact on entitlements for the miscellaneous category, this table only illustrates the impact on total entitlements as a result of changes in the property tax equalization.

TABLE 5

THE EFFECT OF NEW BRUNSWICK'S PROPOSAL ON ENTITLEMENTS

($Millions)

1985-86

	Entitlements With Current Property Tax Base	Entitlements With New Brunswick Proposed Tax Base	Change in Entitlements
Newfoundland	601.0	644.7	43.7
Prince Edward Island	125.0	135.1	10.1
Nova Scotia	568.0	594.0	26.0
New Brunswick	552.0	602.1	50.1
Quebec	2,810.0	2,983.1	173.1
Manitoba	349.0	433.6	84.6
Federal Payout	5,005.0	5,392.6	387.6

The first observation that can be made from Table 5 is that New Brunswick's proposal would increase the cost of the equalization program to the federal government. This however, has to be looked at in the context of the special supplementary equalization that was paid to all recipient provinces this year, and which is to be paid next year as well to Manitoba. In point of fact, New Brunswick's proposal, as an alternative to the supplementary equalization, would only increase federal costs by about $167 million in 1985-86.

Of equal significance is the impact New Brunswick's proposal would have had on equalization payments in the years when transition payments were being made. Had New Brunswick's proposal been in effect since 1982-83, total federal payout would have increased but not by a significant amount. This is shown in Table 6.

TABLE 6

NET INCREASE IN EQUALIZATION ENTITLEMENTS AS A RESULT OF USING NEW BRUNSWICK'S PROPOSED PROPERTY TAX BASE AFTER DECREASE IN TRANSITION PAYMENTS

($Millions)

	1982-83(7)	1983-84(4)	1984-85(3)
Newfoundland	34.2	36.0	38.7
Prince Edward Island	0.0	0.0	0.8
Nova Scotia	0.0	0.0	0.0
New Brunswick	2.4	22.5	43.6
Quebec	0.0	0.0	0.0
Manitoba	0.0	0.0	0.0
Federal Payout (Net Increase)	36.6	58.5	83.1

Table 6 shows that had New Brunswick's proposed property tax base been in effect since 1982, New Brunswick and Newfoundland would have been the main beneficiaries. However, the federal government and the other provinces would have benefited as well. The advantage to the federal government and the other recipient provinces is that the equalization formula itself and not the transition "add on" would have played a much stronger role in determining equalization entitlements.

In 1984-85 11.5 percent of equalization payments or $624 million were paid out to the provinces in transition payments. These payments were determined not on the basis of provincial need as measured by the equalization formula, but as a result of their equalization payments in the 1977 to 1981 period. Had New Brunswick's proposal been in effect, transition payments would have been reduced by about $300 million because basic equalization would have been much higher for all provinces. Federal payments would have increased but they would have been determined to a much greater extent by the equalization formula.

Conclusion

Since the property tax is second only to the personal income tax insofar as total equalization is concerned, it is very important that the property tax base not contain any biases. New Brunswick does not consider the current property tax base to be a realistic and fair reflection of the actual fiscal capacity for property taxes in the provinces.

New Brunswick is concerned that the current property tax base over-states its fiscal capacity to collect property taxes and thereby is depriving it of substantial equalization entitlements. This problem can be corrected by replacing the current property tax base with the one proposed in this paper.

THE PROPERTY TAX BASE IN THE EQUALIZATION FORMULA: A CRITIQUE AND A PROPOSAL FOR CHANGE

ANNEX I

In Table 3 the land values implied by the current proxy property tax base were determined by the following method:

Province	Property Tax Base Value of Land Component 82-83 (8) ($M)	Land Area Net of Fresh Water KM^2	Average Land Value Per KM^2
Newfoundland	1,149.0	370,517	3,101
Prince Edward Island	252.2	5,657	44,582
Nova Scotia	1,960.7	52,841	37,106
New Brunswick	1,613.7	72,092	22,384
Quebec	18,634.1	1,356,791	13,734
Ontario	29,025.5	891,154	32,571
Manitoba	3,042.0	548,495	5,546
Saskatchewan	3,216.2	570,269	5,640
Alberta	10,077.3	644,389	15,639
British Columbia	9,444.8	930,520	10,150
Canada	78,415.5	5,442,741	14,407

SOURCE: Value of land component from the Property Tax Base in 1982-83(8); Land Area for Canada Year Book.

Department of Finance
Province of New Brunswick

October, 1985

COMPARING LEVELS OF TAXATION AMONG PROVINCES
SOME RESERVATIONS ON THE RTS
TAX EFFORT INDICES

Department of Finance
Province of New Brunswick
July 1986

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INTRODUCTION

According to the Constitution, equalization payments "ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

To assess the effectiveness of the current equalization program, it is essential to consider interprovincial comparisons of taxation, fiscal capacity, spending and debt. Federal and Provincial Finance Ministers recognized this last September and agreed that for this round of negotiations it would be important for them to have certain key measures, which when looked at together, would give the federal government and the provinces an appreciation of the relative fiscal circumstances of each province.

The federal Department of Finance recently tabled a document entitled "Technical Paper on Indices of Fiscal Capacity, Tax Effort and Per Capita Expenditures." That document is important because the information contained therein can be used to form an impression of the fiscal circumstances of the provinces. It can also be used, along with other information, to assess the effectiveness of the current equalization program in light of the objectives as laid out in Section 36 of the Constitution.

It is the purpose of this paper to explore the taxation question. In particular this paper examines the index of relative tax effort that has been developed by the federal Department of Finance as a measure to compare "levels of taxation" among provinces.

The federal Department of Finance defines indices of tax effort as providing "measures for each province which indicate the relative extent to which its ability to derive revenues is actually used".[1] Conceptually such an index should reflect the amount of total tax room that is exploited in one province in comparison to the amount of the total that is exploited in other provinces. It follows that such an index should incorporate taxpayer "ability to pay" which has an obvious bearing on a province's ability to derive revenue. To the extent that an index accomplished these tasks, it would be a sound instrument for comparing levels of taxation among provinces.

This paper argues that the index of tax effort of the federal Department of Finance, which has evolved from the data base for the federal equalization program, is actually a more limited measure. This is the case because that index does not give a complete indication of the extent to which one province exploits its tax room in comparison to others, nor does it fully capture differences in the ability to pay among provinces. In large part this is due to inadequacies in tax base definitions and the resulting measures of fiscal capacity from which tax effort indices are derived.

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[1]Canada, Department of Finance, "Technical Paper on Indices of Fiscal Capacity, Tax Effort and Per Capita Expenditures, 1972-73 to 1985-86", (May 20, 1986), p.1.

LIMITATIONS OF TAX EFFORT INDICES

The shortcomings of the index of tax effort arise from its statistical origins in the federal representative tax system (RTS) approach to equalization. As the October 8, 1985 federal discussion paper on indices pointed out: "Since these indices reflect the 1982 representative tax system they will inevitably reflect the strengths and weaknesses of that system". The present tax effort index is based on the tax base definitions of the current equalization program. These tax base definitions apply to all provinces and are used to ascertain each province's relative ability to raise revenue; i.e., its fiscal capacity.

There are several areas which can produce biased or misleading results with the current RTS approach to calculating tax effort. These include: problems with tax base measurement and revenue classification; provincial tax structures; the inclusion of provincial/local public sectors in certain tax base definitions; and the failure to fully measure ability to pay. These are summarized below.

Tax Base Measurement and Revenue Classification

Most tax bases are described by statistics in a way that mirrors as closely as possible the actual base subject to tax. However biases do enter the system, and when they do, they may overstate or understate a province's fiscal capacity and as a result understate or overstate its tax effort. This is also true for revenue data which is entered into the system. If it is not accurate or if classification of revenues

is not strictly comparable among provinces, then the index of tax effort will be biased. Because the index of relative tax effort is sensitive to the data on which it is based it should be interpreted with these possibilities in mind.

Provincial Tax Structure

The mix of taxes used in a province can affect its tax effort. The RTS system does not capture the fact that a province can influence its own fiscal capacity and thus its own tax effort by the tax structure it adopts. This can best be illustrated by examining the relationship between corporate income tax and certain business taxes. If, for example, a province increases its direct business taxes, it will automatically reduce its measured fiscal capacity for the corporate income tax, raise its tax effort index, and in the process shift part of the tax burden of its provincial direct taxes to the federal government.

All provinces do not have the same flexibility to substitute business taxes for corporate income taxes. Among the factors affecting this capacity are the size and distribution of corporate taxable income. To the extent that provincial direct business taxes are utilized proportionately more in some provinces, the tax effort indices will give misleading indicators of relative tax effort.

Inclusion of Provincial/Local Public Sectors in Certain Tax Bases

The tax bases are designed to capture what is available to tax. However, some tax bases reflect the size of the public sector, which results in an exaggeration of these tax bases, since provinces cannot improve their financial situation by taxing themselves. For provinces with relatively large public sectors and relatively small private sectors the result is an overstatement of relative fiscal capacity and an understatement of tax effort.

The Ability to Pay

The tax base definitions attempt to statistically quantify an activity or stock of wealth that is subject to provincial or local taxation. The RTS system assumes that if one jurisdiction levies a tax on a provincially defined tax base, then all other jurisdictions have the same ability to levy the same tax. The problem with this assumption is that the statistical estimates of the tax bases are not fully adjusted for differences in ability to pay among provinces.

The ability to pay provincial direct business taxes, for example, does not depend on the defined tax bases in the RTS system but on the rate and level of profits out of which the taxes are paid. The fiscal capacity and tax effort indices are not adjusted for this. Also, the ability to pay taxes will vary with the amount of tax exportation and tax importation. Tax importing increases the tax burden on local residents and reduces their ability to pay provincial/local taxes levied by their own

governments. At present the tax effort indices are not fully adjusted for the ability to pay and as a result the indices give biased impressions of the relative tax effort among provinces.

The following sections examine each of the above problem areas in more detail.

TAX BASE MEASUREMENT AND REVENUE CLASSIFICATION

Any biases or statistical anomalies in the delineation of the revenues to be equalized and their associated tax bases will influence the tax effort indices. There are two general categories of data problems. One arises from the absence of a direct measure of certain tax bases which necessitates the use of a proxy base which may contain biases. A second set of problems exists when provincial revenues are not treated consistently in the calculation of revenues to be equalized. The effect of these two general problems on tax effort indices are illustrated below using the property tax base and the treatment of provincial insurance revenues for non-commercial vehicles as examples.

Sensitivity of Tax Effort Index to an Alternative Property Tax Base:

Table I contains indices of tax effort, based on the data contained in the special unofficial estimate of equalization for 1985-86 done in March 1986 by the federal Department of Finance. Column 1 displays the indices of tax effort associated with that estimate, and in this case the property tax base is the actual base used, and provided for by the current regulations.

Column 2 gives indices of tax effort with the same revenue and population data as Column 1 but with a property tax base as outlined by the federal Department of Finance in a document entitled "The Tax Base for Property Taxes", May 20, 1986. Column 3 is based on the same revenue and population data as Column 1, but with a property tax base as proposed by New Brunswick in a document entitled "The Property Tax Base in the Equalization Formula: A Critique and Proposal for Change", August, 1985.

TABLE I

TAX EFFORT WITH ALTERNATIVE TAX BASE DEFINITIONS FOR THE PROPERTY TAX

	(1) Current Property Tax Base	(2) Federal Proposed Property Tax Base	(3) New Brunswick Proposed Property Tax Base
Newfoundland	106.0	107.5	110.9
Prince Edward Island	90.5	93.2	95.3
Nova Scotia	92.8	93.3	94.6
New Brunswick	99.0	100.5	103.0
Quebec	121.9	121.7	122.5
Ontario	100.5	99.8	98.1
Manitoba	108.4	109.5	113.3
Saskatchewan	98.1	98.8	102.1
Alberta	76.9	77.8	76.6
British Columbia	96.3	95.8	99.3
Canada	100.0	100.0	100.0

Table I illustrates the sensitivity of tax effort indices to alternative tax base definitions, in this case the property tax. It is clear that overall indices of tax effort can be changed significantly by alternative tax base definitions as has been illustrated with the above example.

Sensitivity of Tax Effort Index to Treatment of Motor Vehicle Insurance Revenue:

Despite the fact that provincial governments submit revenue data which is ultimately determined by Statistics Canada, some problems remain. Biases are introduced when provincial revenues are not treated consistently for each province. This can be illustrated by examining Table II.

TABLE II

TAX EFFORT WITH ALTERNATIVE TREATMENT

OF MOTOR VEHICLE INSURANCE REVENUE

	(1) Current Treatment of Motor Vehicle Insurance Premiums as Non-Commercial Vehicle Revenues	(2) Motor Vehicle Insurance Premiums Removed from Non-Commercial Vehicle Revenues
Newfoundland	106.0	106.5
Prince Edward Island	90.5	91.2
Nova Scotia	92.8	93.3
New Brunswick	99.0	99.6
Quebec	121.9	120.3
Ontario	100.5	101.0
Manitoba	108.4	109.1
Saskatchewan	98.1	98.5
Alberta	76.9	77.1
British Columbia	96.3	96.9
Canada	100.0	100.0

Table II contains indices of tax effort which are also based on the data used in the special March, 1986 estimate of equalization for 1985-86. Column 1 is the actual tax effort indices arising from that estimate, and in this case Quebec's unique treatment of motor vehicle insurance premiums as non-commercial vehicle license revenues has been retained. Column 2 on the other hand uses the same tax base and population data as Column 1 but an adjustment has been made to non-commercial vehicle revenues, whereby Quebec's revenues for this source were put on the same basis as the Province of Ontario, which is typical of the country as a whole.

Table II shows that putting the treatment of non-commercial motor vehicle insurance revenues on a standardized basis by itself significantly changes the tax effort indices. Clearly, where revenues are not treated consistently across provinces, the tax effort indices will give a misleading impression of levels of taxation among provinces.

PROVINCIAL TAX STRUCTURE

The mix of taxes a province chooses to exploit can alter its tax effort while not affecting its total revenue because some provincial business taxes are deductible against the corporate income tax base.

The following example illustrates the sensitivity of a province's tax effort to its tax structure. In this example it is assumed that paid-up capital and payroll taxes, which are paid primarily by corporations, are fully deductible from corporate income for purposes of determining corporate income tax. Because not all provinces use the payroll tax or the

paid-up capital tax the fact that these taxes are deductible from corporate income affects the relative tax effort indices of all provinces.

Table III illustrates this effect on tax effort. Column 1 shows tax effort indices from the special March 1986 estimate of equalization for 1985-86. Column 2 shows what tax effort would be if those provinces which utilized the payroll and paid-up capital taxes eliminated those taxes and raised the same amount via the corporate income tax.

TABLE III

TAX EFFORT ADJUSTED TO INCLUDE

PAYROLL AND CAPITAL TAX IN CORPORATE INCOME TAX

1985-86 SPECIAL MARCH 1986 ESTIMATE

Province	(1) Original Tax Effort	(2) Adjusted For Payroll & Capital Tax
Newfoundland	106.0	107.2
Prince Edward Island	90.5	91.7
Nova Scotia	92.8	94.4
New Brunswick	99.0	100.6
Quebec	121.9	120.4
Ontario	100.5	101.2
Manitoba	108.4	109.4
Saskatchewan	98.1	98.6
Alberta	76.9	75.9
British Columbia	96.3	97.6
Canada	100.0	100.0

Table III shows that through its choice of direct business taxes, a province can influence tax effort indices. If a province increases its dependence on direct business taxes it will also reduce its overall fiscal capacity, and at the same time increase its tax effort index. In provinces where there is a greater ability to pay direct business taxes there will be a tendency for a relatively greater reliance on these taxes. The result will be a general overestimation of tax effort in those provinces and a general underestimation of tax effort in the other provinces.

INCLUSION OF PROVINCIAL/LOCAL PUBLIC SECTORS IN CERTAIN TAX BASE DEFINITIONS

Generally tax base measures are adjusted to account for the fact that provincial/local governments cannot affect their overall fiscal positions by taxing themselves. However, there are cases where these adjustments are incomplete or have been overlooked. To the extent that this occurs a province's tax effort may be overstated. This section will illustrate this problem with respect to the payroll tax and hospital-medical insurance premiums.

The present payroll tax base does not adjust for the wages and salaries of provincial/local public sector employees. Since the payroll tax is levied on employers, a payroll tax on the public sector would not affect a provincial government's fiscal position. It follows therefore that provincial/local public sector wages and salaries should be excluded from the tax base; and an estimate of the payroll taxes associated with those employees should be excluded on the revenue side.

Table IV shows the impact of making these adjustments on New Brunswick's tax effort index. For payroll taxes, the changes increase New Brunswick's tax effort index from 99.0 to 99.6. If a similar adjustment is made for hospital-medical insurance premiums, on the assumption that such premiums are eventually paid by the employer, New Brunswick's tax effort index increases to 100.6. All provinces cannot be shown in Table IV because of insufficient data.

TABLE IV

ANALYSIS OF SENSITIVITY OF TAX EFFORT

TO EXCLUSION OF GOVERNMENT SECTOR PASS THROUGHS

	New Brunswick Tax Effort
Special March 1986 Estimate for 1985-86	99.0
Excluding Provincial Government[a] from Both Revenue and Tax Base Data	
- From Payroll	99.6
- From Hospital Insurance Premiums	99.9
- From Both	100.6

[a]Provincial government includes local administration, provincial administration, education and related services and health and welfare services.

SOURCE: Based on Provincial Fiscal Equalization Data, Special unofficial March 1986 estimate of equalization for 1985-86.

Table IV demonstrates that the federal tax effort indices tend to have a significant bias when adjustments have not been made for the size of the public sector. The federal tax effort indices presently underestimate the tax effort of New Brunswick and other provinces with relatively weak economies and therefore relatively large public sectors.

ABILITY TO PAY AND TAX EFFORT INDICES

One of the most serious shortcomings of the tax effort indices is that they do not fully take into account differences in the ability to pay among provinces. These differences arise because of a number of factors including the net importation of taxes, the varying rates of return to capital, and differences in the distribution of income. Because of these shortcomings the ability of poorer provinces to raise taxes may be considerably less than the tax effort indices imply.

Exporting and Importing of Taxes

Importation of taxes increases the tax burden of a province's residents and reduces their ability to pay additional taxes. Exportation of taxes has the opposite effect. In provinces like New Brunswick, which import more taxes than they export, the effect is to increase tax burden on their citizens and reduce their ability to pay additional taxes. This reduced ability to pay additional taxes is not reflected in the federal tax effort indices.

Although taxes may be exported and imported through a number of mechanisms, this paper will examine the two which are generally considered to have the most significant implications for tax effort calculations: the higher federal rates which are necessitated by the deductibility of certain provincial-local business taxes against federal income tax liability, and the forward shifting of business taxes to out-of-province consumers.

Higher federal rates are necessary to offset lost federal revenue resulting from the deductibility of certain provincial direct taxes against federal business income tax liability. These higher rates tend to result in net importation of taxes into provinces like New Brunswick that have chosen not to levy paid-up capital or payroll business taxes. Because paid-up capital and payroll taxes can be used as business deductions against federal corporate income tax, provinces having such taxes benefit by shifting a part of their tax burden to the federal government while provinces like New Brunswick do not. At the same time citizens in provinces which do not have these direct business taxes must pay the higher federal tax rates which are necessary to offset the lost federal revenue.

Some provinces are net importers of taxation as a result of forward shifting of business taxes. New Brunswick, for example, imports a much higher value of manufactured goods than it exports to other provinces with a resulting net importation of tax burden. Based on interprovincial trade estimates of Statistics Canada, New Brunswick's 1979 exports to the rest of Canada were valued at 2.1 billion dollars while its

imports from the rest of Canada were 3.5 billion dollars. At the same time, New Brunswick's major exports are raw or semi-processed resources with less opportunity for forward shifting of business taxes.

Because New Brunswick is a net importer of goods from the other provinces, it also is a net importer of a significant amount of other provinces' taxes. This reduces the ability of New Brunswick citizens to pay additional taxes. As a result the tax effort indices underestimate the levels of taxation of provinces like New Brunswick.

The Ability to Pay Per Unit of Tax Base

While the federal RTS system makes adjustments for interprovincial variations in ability to pay in the case of the personal income tax and by the exclusion of certain items such as food and clothing from the sales tax base; there are several other tax bases which are not adjusted to reflect differences in the ability to pay among provinces. This is especially the case for certain business taxes.

The ability of poorer provinces to pay business taxes is significantly overstated in the tax effort indices because ability to pay adjustments have not been made. Businesses with consistently lower profits do not have the same ability to pay taxes out of each dollar of wages or paid-up capital as businesses with higher profits. It follows that provinces with a higher proportion of low profit businesses will have a fiscal capacity for business-type taxes which is considerably less than that suggested by the federal tax base estimates.

Table V illustrates the lower ability to pay business direct taxes out of corporate profits in New Brunswick. In the case of paid-up capital taxes, payroll taxes and the employers' payment of hospital-medical insurance premiums, the actual ability to pay is measured by business profits. In New Brunswick there are fewer dollars of profit per unit of the representative tax base for all three types of business taxes when compared to the ten-province average. In all cases but one, New Brunswick's ability to pay per unit of tax base is less than half the national average, yet there is no adjustment for this in the current tax effort indices. Thus, for provinces like New Brunswick, the federal tax effort index will be based on a significant overestimation of the business tax base with a resulting underestimation of tax effort relative to other provinces.

TABLE V

DOLLARS OF CORPORATE PROFITS

(BEFORE TAXES) PER UNIT OF TAX BASES

	1982	1983	1984
Paid-Up Capital			
Canada	.0485	.0703	.0858
New Brunswick	.0293	.0297	.0382
New Brunswick/Canada	.604	.422	.445
Hospital-Medical			
Canada	2156	3181	3882
New Brunswick	727	817	1050
New Brunswick/Canada	.337	.257	.270
Payroll			
Canada	.1217	.1709	.2086
New Brunswick	.0524	.0545	.0701
New Brunswick/Canada	.431	.319	.336

SOURCES: Statistics Canada 13-213, and Fiscal Equalization Estimates.

SUMMARY AND CONCLUSION

Both conceptually and empirically it is difficult to accurately compare provincial levels of taxation. The index of relative tax effort is the best such measure presently available, but it must be interpreted with caution.

The tax effort indices of the federal Department of Finance reflect the limitations of the representative tax system. These deficiencies include the problems with tax base definitions, the revenue classification procedures utilized, the impact of provincial tax structures on tax effort, and the inclusion of the provincial/local public sector in the tax base definitions. This paper has illustrated biases that are inherent in the federal tax effort indices as they are not adjusted for these matters. While the examples are not exhaustive, they do illustrate a significant impact on the indices as shown in the following table.

TABLE VI

COMPARISON OF THE CURRENT ESTIMATE
OF TAX EFFORT AND ADJUSTED TAX EFFORT

Province	Current Estimate of Tax Effort	Adjusted Tax Effort
Newfoundland	106.0	109.3
Prince Edward Island	90.5	95.3
Nova Scotia	92.8	95.6
New Brunswick	99.0	102.8
Quebec	121.9	118.6
Ontario	100.5	100.9
Manitoba	108.4	111.1
Saskatchewan	98.1	99.6
Alberta	76.9	77.0
British Columbia	96.3	97.5
Canada	100.0	100.0

The first column in Table VI shows tax effort indices based on the special March 1986 estimate of equalization for 1985-86. The second column shows what tax effort would be as a result of using the proposed federal property tax base, treating non-commercial vehicle revenue on a consistent basis, and on the assumption that payroll and capital taxes are raised via the corporate income tax. Because the necessary information was not available, the adjustment for the government sector in the tax bases was not made. Even without making this particular adjustment, the table indicates rather significant changes in the tax effort indices in a number of provinces.

In addition, the paper pointed out that the federal tax effort indices do not fully reflect differences in the ability to pay among provinces. While it has not been possible to numerically illustrate this fact insofar as the tax effort indices are concerned, the paper has pointed out that failure to adjust for ability to pay tends to overstate fiscal capacity and understate tax effort for the poorer provinces.

The purpose of this paper has been to examine the federal tax effort index as a measure to compare levels of taxation among provinces. This examination has revealed that while the tax effort indices may be generally indicative of relative tax effort, there are significant inadequacies that limit their precise interpretation. These factors must be borne in mind when the indices are used for comparing levels of taxation among provinces. The indices must be interpreted in conjunction with what is known of the tax structure of individual provinces, the varying ability to pay among provinces, and the nature of the RTS system itself.

A PROPOSAL TO EXTEND THE APPLICATION OF AN URBAN SCALE WEIGHT TO COMMERCIAL LAND VALUES IN THE PROPERTY TAX BASE

Department of Finance
Province of New Brunswick
October 16, 1986

BACKGROUND

For the past year federal and provincial officials have been looking at the technical construction of a number of tax bases which are used in the equalization formula.

As an equalization receiving province, New Brunswick has strongly supported this work. Any improvement in measuring the ability to raise revenues, which comes out of a review of the tax bases, adds to the credibility of the equalization program.

The federal Department of Finance at the officials' level, tabled a document in late May which reviewed the work that had gone on over the past year. In that document there were suggestions to improve a number of the equalization tax bases.

Changes were proposed for the tax bases for sales tax, coal revenues, potash revenues, lottery revenues and property taxes. The purpose of the proposed changes in these tax bases would be to make such bases a closer reflection of the construction of the actual tax bases in use in Canada.

Changes to the property tax base are the most significant and these changes have the greatest financial impact on equalization payments. The key change from the present property tax base is that the proposed new tax base would consist of three components: agricultural, commercial and residential, and that the residential land component would be weighted to account for the fact that the value of residential land increases with urban scale. The financial effect of the original federal proposed changes to the property tax base are shown in Column 1 in the attached appendix to this paper.

During the past summer, partly in response to criticism by the Province of Quebec, the federal Department of Finance re-examined its proposed changes to the property tax base and in late August tabled an amendment to its original proposal. This amendment consisted of a change to the way in which the urban scale factor for weighting the residential land component would be determined. The effect of this particular adjustment, which can be seen in column 2 of the attached appendix, would be to significantly increase entitlements to the Province of Quebec.

NEW BRUNSWICK'S PROPOSAL

At the September 19 Finance Ministers' meeting, and in discussions at the officials' level, New Brunswick has indicated its general support for the changes to the property tax base as proposed by the federal government insofar as residential land is concerned. However, New Brunswick does not believe that the proposed changes adequately address the problem of measuring the property tax bases of the provinces. In this regard, New Brunswick is of the view that since there is reason to give weight to the fact that the cost of residential land increases with urban scale, there is an equal or better case for also weighting commercial land to reflect the fact that commercial land values increase with urban scale.

As far as New Brunswick is concerned, weighting commercial land values to account for increased costs associated with urbanization, together with such weighting for residential land, would represent a significantly improved and consistent approach to the measurement of land values in the property tax base. This could be achieved by using the same

urban scale factor to weight commercial land costs that is proposed by the federal government to weight residential land. The financial effect of New Brunswick's proposal can be seen in column 3 of the attached appendix.

EVIDENCE IN SUPPORT OF NEW BRUNSWICK'S PROPOSAL

New Brunswick's proposal is consistent with the principle that an urban scale factor should be constructed "to recognize the impact of urban population on land values", (Department of Finance, May 1986). According to the federal Department of Finance, "the urban scale element would be derived from observed statistical relationships between property values and urban population, taking account of the fact that property values tend strongly to increase with population size". A cursory look at economic geography will support this as a fundamental determinant of land values.

There is no conceptual justification for limiting the application of urban scale weights to residential land. Indeed, urban scale will have a stronger impact on commercial land values than on residential land values because it is essential for commercial land to be located in accessible core areas, while residential areas can be located further from the prime real estate, (Short 1984). "Since land is leased out or sold to the highest bidder, we can identify different land users by their ability to pay." Commercial and retail enterprises depend upon face to face contact in business dealings and their ability to attract customers, for which they are willing and able to pay greater sums for prime locations. In contrast, the residential sector is unable and unwilling to outbid commercial enterprises for central locations and will

have a lower rent bid function. A rent-bid function is "defined as the amount of rent a firm or household can afford to pay at different locations", (Short 1984).

If only residential and agriculture land uses were to bid for land, then land prices would not be so high. "The value of land at a particular point in time and space reflects pressures in the market place, the overall condition of the economy, the preferences of the various actors involved, and their abilities and levels of knowledge, and generally, all of the factors - institutional, cultural and economic - that impinge upon the value of real estate", (Bryant et. al. 1982).

Increased population density in an area raises the the demand for available land. Implicit in this fundamental premise of urban geography is the myriad of economic effects associated with an increasing population; higher demand, higher incomes, and higher land costs. In addition, since a large market of consumers can be found in an urban area, substantial economies of scale can be realized and many commodities and commercial services will be produced in that area for national markets.

"Large urban areas tend to produce a greater variety of goods and services than small areas. This can be determined empirically by examining the array of goods and services in the Yellow Pages of the telephone directory of various urban areas", (Screiber, Gatons, Clemmer 1976). The larger the size of the population in an area, the greater variety of goods and services will be produced, in turn attracting more people. From a suppliers viewpoint, "an urban area with a large population may offer an incoming firm a potential cost

advantage over a smaller area". This accounts for the increased commercial land costs associated with larger urban centers.

CONCLUSION

The federal Department of Finance has accepted the fact that urban scale affects residential land costs and its proposal to deal with this fact in the property tax base represents an improvement to that tax base. However if the property tax base is to fairly reflect fiscal capacity, equally appropriate arguments can be found to support the fact that urban scale is also responsible for increased commercial land costs. Indeed, differences in commercial land costs are likely to be even more extreme in Canada than residential land costs. For this reason therefore, New Brunswick is firm in its belief that only by applying a urban scale factor to both residential and commercial land costs can the property tax base be improved to consistently and fairly represent the underlying value of property upon which taxes are levied in Canada.

In putting this proposal forward, New Brunswick would ask that the following points be borne in mind:

1) Applying the same urban scale factor to commercial land that is to be applied to residential land can be supported in theory and in practice;

2) The additional cost to the federal equalization program as a result of applying an urban scale factor to commercial land is relatively small given the overall cost of the federal equalization program, i.e., $57 million on a program that costs over $5 billion;

3) With the exception of the Province of Quebec, which benefits substantially from the change in the derivation of the urban scale factor as proposed by the federal Department of Finance in late August, all receiving provinces would benefit from New Brunswick's proposal. The effect on Quebec would be a marginal loss in respect of its overall gain which is still the largest of all receiving provinces.

APPENDIX I

FINANCIAL IMPACT ARISING FROM CHANGES TO THE PROPERTY TAX BASE

1985-86

($Millions)

	Original Federal Proposal May 23/86	Latest Federal Proposal August 28/86	New Brunswick Amendment to Latest Federal Proposal September 17/86
Newfoundland	+21.4	+21.4	+31.4
Prince Edward Island	+7.9	+7.5	+10.0
Nova Scotia	+21.1	+20.3	+37.1
New Brunswick	+31.7	+31.8	+47.2
Quebec	+49.5	+79.6	+76.7
Manitoba	+34.8	+35.6	+51.5
Federal Cost[1]	+166.4	+196.3	+253.9

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1 These estimates of federal cost increases must be viewed in the context of cost savings arising from proposed changes in other tax bases to get an appreciation of the overall effect of tax base changes on federal program costs.

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A PROPOSAL TO IMPROVE THE PAID-UP CAPITAL TAX BASE TO REFLECT INTERPROVINCIAL DIFFERENCES IN ABILITY TO PAY

Department of Finance
Province of New Brunswick
October 20, 1986

Background

While the federal RTS system makes adjustments for interprovincial variations in ability to pay in the case of personal income tax and by the exclusion of certain items such as food and clothing from the sales tax base; there are several other tax bases which are not adjusted to reflect differences in ability to pay among provinces. This is especially the case for certain business taxes and in particular the capital tax.

The fiscal capacity of poorer provinces to collect capital taxes is overstated in the current tax base because ability to pay adjustments have not been made. Businesses with consistently lower profits per dollar of paid-up capital tax base have lower ability to pay than do businesses with higher profits per unit of the tax base.

Current Tax Base

The current capital tax base is calculated by aggregating a) paid-up capital employed in the province (includes: agricultural, forestry, fishing, mining, construction, utilities, wholesale trade, retail trade, services, and the financial industry except deposit accepting institutions), and b) 2.5 times the total equity employed in the province in the year of all corporations classified by Statistics Canada in the deposit accepting institutions industry.

Problems with the Current Tax Base

The capital tax base estimate implicitly assumes that all provinces have equal ability to generate revenue per unit of the tax base, (i.e., per dollar of paid-up capital). This represents a clear bias favoring provinces with higher corporate profits per unit of the tax base and discriminating against those provinces with lower than average corporate profits per unit of the assessed tax base.

New Brunswick's Proposal to Eliminate the Bias in the Capital Tax Base

An accurate measure of fiscal capacity for this source must consider the ability of a firm to pay this tax. In poorer provinces profit margins tend to be relatively low. It follows therefore that by simply applying a national average tax rate to the existing equalization tax base, the revenue raising ability of poorer provinces will be overstated.

New Brunswick proposes that an improved measure of the paid-up capital tax base can be derived by adjusting the existing paid-up capital tax base for differences in ability to pay corporate taxes per unit of the representative tax base. This can be accomplished by adjusting each province's paid-up capital tax base as defined by the equalization program according to corporate profitability. (See appendix for how this was calculated.)

Using this approach, a new equalization tax base for paid-up capital can be calculated for each province by comparing ability to pay of each to the national average ability to pay and by multiplying this ratio by the respective current equalization tax bases for paid-up capital. These new tax bases, when applied to the equalization data base yield the following changes in entitlements.

FINANCIAL IMPACT ARISING FROM
CHANGES TO CAPITAL TAX BASE
1985-86(3)
($Thousands)

Nfld.	P.E.I.	N. S.	N. B.	Que.	Man.	Federal Cost
+2,499	+ 474	+11,321	+7,509	-6,202	+1,419	$17,020

Conclusion

The purpose of this paper has been to comment on the bias in the existing calculation of the capital tax base for equalization entitlements, and to propose a way to eliminate this bias.

The result is that incorporating a measure of ability to pay capital taxes provides a fairer way to estimate fiscal capacity for purposes of determining equalization payments.

APPENDIX

	Nfld	P.E.I.	N. S.	N. B.	Que.	Ont.	Man.	Sask.	Alta.	B. C.	Canada
1)	Corporate Profits Before Tax (1984)	332.0	83.0	236.0	279.0	7,577.0	15,051.0	1,013.0	1,992.0	12,538.0	2,820.0	41,921.0
2)	Tax Base for Paid-Up Capital (1985-86)(3)	6,034.0	1,416.5	9,391.9	7,926.4	99,860.0	205,266.2	14,648.4	14,505.9	120,796.7	47,018.1	526,864.1
3)	Ratio of Corporate Profits to Tax Base (Line 1 ÷ Line 2)	.0550	.0586	.0251	.0352	.0759	.0733	.0692	.1373	.1038	.0599	.0796*
4)	Provincial Ratio to National Averate Ratio (Line 3 ÷ National Average Ratio* of Corporate Profits to Paid-Up Capital Tax Base)	.6909	.7362	.3153	.4422	.9535	.9208	.8693	1.7248	1.3040	.7525	
5)	Revised Tax Base for Paid-Up Capital (Line 2 times Line 4)	4,168.9	1,042.8	2,961.3	3,505.1	95,216.5	189,009.1	12,733.9	25,071.9	157,518.9	35,381.1	526,609.5

A PROPOSAL TO IMPROVE THE PAYROLL TAX BASE

Department of Finance
Province of New Brunswick
October 20, 1986

Background

Generally, tax base measures in the equalization formula are adjusted to account for the fact that provincial-local governments cannot affect their overall fiscal positions by taxing themselves. There are cases however, where these adjustments are incomplete or have been overlooked. When these adjustments have not been made, provincial fiscal capacities are not measured correctly. The purpose of this note is to propose a solution to this problem with respect to the payroll tax.

Current Tax Base

The present payroll tax base consists of the sum of wages, salaries and military pay and allowances excluding supplemental labor income. The problem with this measure as a tax base for payroll taxes is that it has not been adjusted for the wages and salaries of provincial-local public sector employees including hospital workers and education sector employees.

Since the payroll tax is levied on employers, a payroll tax which included provincial-local public sector employees, hospital workers and education workers, would overstate a provincial government's net fiscal position since it would have to pay such levies. It follows therefore that a more realistic measure of fiscal capacity to collect payroll taxes could be derived by taking the wages and salaries of provincial-local employees, hospital workers and education sector employees out of the existing payroll tax base.

New Brunswick's Proposal to Improve the Payroll Tax Base

New Brunswick proposes that the payroll tax base would be improved significantly if the current tax base were adjusted to reflect the fact that a payroll tax on public sector employee wage bills would have to be paid by each province, and that for this reason it makes little sense to include an estimate of the ability of a provincial government to tax itself in measuring its fiscal capacity to collect payroll taxes.

A new equalization tax base for payroll taxes could be derived by subtracting the wages and salaries of provincial-local governments, hospitals and the education sector from the current payroll tax base. The new tax base would give an indication of the fiscal capacity to collect payroll taxes from all but the provincial-local government sector.

The financial impact of this proposed change can be seen in the following table.

FINANCIAL IMPACT ARISING FROM CHANGES
TO THE PAYROLL TAX BASE - 1985-86(3)
($Thousands)

Newfoundland	3,101
Prince Edward Island	683
Nova Scotia	2,204
New Brunswick	2,170
Quebec	17,936
Manitoba	2,817
Federal Cost	28,911

Conclusion

The purpose of this paper has been to point out that the current payroll tax base presently overstates the fiscal capacity to collect payroll taxes in provinces with relatively weak economies, and therefore relatively large public sectors. The proposal to adjust the current payroll tax base to account for the fact that provinces cannot improve their fiscal position by levying a payroll tax on themselves would make the payroll tax base a fairer measure of fiscal capacity.

APPENDIX 7

STATEMENTS PERTAINING TO FISCAL ARRANGEMENTS

BY NEW BRUNSWICK'S MINISTER OF FINANCE

SEPTEMBER 1985 TO DECEMBER 1986

DELIVERED TO FEDERAL-PROVINCIAL FINANCE MINISTERS' MEETINGS

NOTES FOR A STATEMENT ON FISCAL ARRANGEMENTS

BY

HONOURABLE JOHN B.M. BAXTER, Q.C.

MINISTER OF FINANCE

PROVINCE OF NEW BRUNSWICK

SEPTEMBER 1985

Mr. Chairman, fiscal arrangements are of critical importance to New Brunswick and the Atlantic region, and the Government of New Brunswick places a high priority on the renegotiations of these arrangements in the coming year.

As you are aware, New Brunswick has had a difficult time in the past few years. We have had to live with the changes the federal government made in 1982 in health care and post-secondary education financing. And we have had to cope with an equalization program, which has not worked as intended.

The result of the previous federal government's legacy in terms of fiscal arrangements is that we have been placed in a position where we cannot provide New Brunswickers with services comparable to Canadians as a whole, despite major tax increases and substantially increased deficits. In the words of Section 36(2) of the Constitution, New Brunswick has not been able "...to provide reasonably comparable levels of public service at reasonably comparable levels of taxation".

New Brunswick is approaching this round of discussions on fiscal arrangements with the changes which were made in EPF and equalization in 1982 clearly in mind. It is absolutely essential that the 1987 fiscal arrangements deal with major inequities which have been developing in Canada for a number of years, and which the 1982 fiscal arrangements failed to address. We are looking to your Government to deal with this problem.

Having said this I am disappointed that we are beginning our discussions about equalization and established programs financing with the spectre of your comments about fiscal arrangements in your recent Budget Speech hanging over us. To quote from your Budget you said:

> "To spread the burden of expenditure reduction fairly, the government will also be seeking to limit the rate of growth of transfers to provinces to yield annual savings of $2 billion by the end of the decade".

Mr. Chairman, I cannot fault your attempt to reduce federal expenditures. But to do this simply by transferring part of your financial problem to the Provinces is not a solution. For the country as a whole, it makes little sense to move the deficit around, particularly to provinces that already have serious deficit problems.

Over the past decade or more, Canadians have built health care and higher education systems which have served Canada well. It has been federal funding which has made this possible. We have also developed an equalization program, which while not perfect, has noble objectives. It has enabled the poorer provinces to give services to their citizens which they could not provide on their own.

Mr. Chairman, "to spread the burden of expenditure reduction fairly," to use words from your Budget Speech, EPF and equalization must have a higher national priority than many other areas of federal concern. Surely, fairness requires that these programs receive preferential treatment by the federal government in its attack on its deficit. To do otherwise, is to say that the federal government no longer believes that comparable levels of services to citizens at comparable levels of taxation is a national priority.

In addition to these general comments, Mr. Chairman, there are a number of specific issues which I want to raise as we begin to discuss these important national programs. In this regard the process leading up to the 1987 fiscal arrangements is very important. As we begin to discuss equalization and EPF, I believe it essential that we agree discussion of these two programs must be brought together at some point so the overall impact of fiscal arrangements for the 1987-1992 period can be assessed.

With the Johnson Report on Post-Secondary Education, the MacDonald Royal Commission and the Neilson Task Force, I also believe it is very important that we as Finance Ministers set our own agenda and not be driven by events. For example, with EPF I would like to be assured that you Mr. Wilson will represent the federal government in the discussions on financing health care and post-secondary education.

In their comminuqué after their recent conference in St. John's, the Premiers made their position very clear. They have instructed their Finance Ministers to represent the Provinces in the discussions on fiscal arrangements, equalization and established programs financing. I hope the federal government will give you the same mandate, and that if you are thinking about cuts in transfer payments, your colleagues will not at the same time be encouraging Provinces to spend more or chastising them for attempting to control expenditures.

I would also like to know whether the current Government of Canada endorses the original principles on which the EPF program was based. You will recall that when established programs financing was introduced in 1977 federal financing for health care and post-secondary education was placed in a block fund. This arrangement gave the Provinces flexibility to plan and deliver health care and post-secondary education services and it placed a limit on federal payments for these services.

Despite the advantages of the EPF arrangement for both levels of government, shortly after it was put into place the previous federal government began to refer to separate health care and post-secondary education financing arrangements, and indeed in 1983 put a cap on federal contributions for post-secondary education. Mr. Chairman, it is important to know the rules of the game; will you be dealing with EPF as a block fund program as originally established, or will you be carrying on with the artificial notion of separate health care and post-secondary education financing arrangements, which the previous government concocted in the early 1980's?

New Brunswick is convinced, Mr. Chairman, that the current equalization program is not meeting its objectives. Indeed, I suggest that the equalization program is failing to meet its constitutional obligations. For this reason, I believe we should conduct a full evaluation of the 1982 program before we begin to talk about changing it. If we are to consider changing equalization we should be fully aware of the shortcomings of the program we now have. I understand this was agreed to at the Deputies' meeting last week.

Mr. Chairman, one of the most significant shortcomings during the last round of fiscal arrangements discussions was the absence of information pertaining to the fiscal circumstances of the provinces. As a result, the 1982 fiscal arrangements emerged with the federal government having a very limited appreciation of the fiscal implications those arrangements would have on the Provinces. Indeed, the previous administration gave the impression it did not want to know what its proposals would mean to Canadians across the country.

I am advised that the Deputies in their meeting last week also agreed to have the Fiscal Arrangements Subcommittee produce this information. I think that work is essential in putting our discussions on fiscal arrangements in the proper context, and I look forward to discussing the results of that assignment with you Minister and my Provincial colleagues.

Before leaving equalization, I want to stress that while we are interested in the principles of the equalization program, we are also interested in the nuts and bolts of the program as well. In this regard we will want officials to have a close look at a number of tax bases used in the formula. You are aware of our concerns about the property tax base; during the next year we will also be documenting our concerns about some of the other tax bases as well.

My final observation concerns the Tax Collection Agreement. We want the Tax Collection Agreement to be maintained. We think it is a sensible and logical way to deal with federal and provincial income tax administration. However, we are concerned about a number of recent developments. Federal tax reform, forecasts of federal basic tax, tax simplification, etc., have an important provincial as well as federal dimension. If the Tax Collection Agreement is to continue, the difficulties which issues such as these create for the Provinces, must receive far greater priority from the current government than from the old.

Mr. Chairman, the federal government has set national reconciliation and harmonious federal-provincial relations as important national objectives. As we begin to discuss fiscal arrangements for the 1987-1992 period, I think it will be very important for all of us to keep these objectives clearly in mind. We all serve the same taxpayers, and it is essential that in our discussions, we end up with an equalization program and financial arrangements for health care and post-secondary education, which will be equitable and fair to all parts of the country.

NOTES FOR A STATEMENT

ON

ESTABLISHED PROGRAMS FINANCING

BY

HONOURABLE YVON POITRAS

PROVINCE OF NEW BRUNSWICK

DECEMBER 1985

Mr. Chairman, the Government of New Brunswick has had a major deficit problem since the 1982 recession. We recognized at an early stage that our deficit had to be reduced, and for three years we have been taking measures to do this.

The result is that New Brunswick has cut spending to the bone. We have frozen public servants' salaries for two years including hospital workers and teachers. Our doctors have taken a one year freeze on their medicare fee schedules; we have postponed needed maintenance and capital investment, and we have trimmed our public service.

We have also raised taxes significantly and we have introduced new taxes as well. We have a three year plan to eliminate the ordinary account deficit. It was not envisaged that the federal government would change EPF before 1987; consequently, reductions in EPF next year will be a serious setback for our plan.

Mr. Chairman, within the content of what we have done, your plan to cut EPF payments beginning next year is unacceptable to the Province of New Brunswick. It is unacceptable because it will add further to the tough measures that the Province has already adopted to eliminate our ordinary account deficit. As a national strategy to deal with public sector deficits, cutting federal EPF payments will not accomplish anything insofar as the total public sector is concerned. Reducing funds available to provinces will simply lead to increased provincial deficits or expenditure cuts and tax increases at the provincial level. Essential programs will continue, even if federal support for them is reduced. Provinces may just have to borrow more.

Cutting EPF payments cannot be justified if the federal government uses any savings it obtains to finance new initiatives. Health and education are programs of fundamental importance to Canada and federal commitment to them must be maintained.

Federal cutbacks in these programs cannot be justified if the federal government has not imposed same degree of spending restraint as many of the provinces have done. With respect, I do not believe that the federal government has looked closely enough at its own internal operations.

The federal government has never imposed the type of wage restraint on its employees that the provinces have done. For example, just last week it was announced that federal salaries will significantly increase again this year. New Brunswick public servants in contrast have been given two zero years and there have been similar wage practices in many of the provinces.

I am disappointed that cuts will be made in EPF before our officials have completed the work that we asked them to do on the operations of the whole transfer system. To proceed with these cuts without knowing how they will affect the various provinces and regions of Canada is, in my view, unwise and short-sighted.

Mr. Chairman, the Government of New Brunswick faced a very difficult time in bringing our ordinary account into balance before you announced cuts in EPF for next year. If you proceed as announced the Government of New Brunswick will be forced to more stringent restraint measures and more borrowing which will result in a reduced credit rating. That should be of concern to the Minister of Finance and the Government of Canada.

There was an agreement, there was an understanding, that the new arrangements entered into in 1982 would continue for five years. I am simply asking that you honour that agreement. If you proceed as proposed in 1986-87 you will create an atmosphere of distrust which will poison federal-provincial relations for years to come.

NOTES FOR STATEMENT ON FISCAL ARRANGEMENTS

BY

HONOURABLE JOHN B. M. BAXTER, Q.C.

MINISTER OF FINANCE

PROVINCE OF NEW BRUNSWICK

SEPTEMBER 1986

Mr. Chairman:

I am pleased that fiscal arrangements is the top item on today's agenda. There are a few other issues that are as important to New Brunswick or the entire Atlantic Region for that matter, as the new equalization program, which we expect to remain in place until 1992.

It is difficult to look ahead five years and make even reasonable guesses about where our economies are going or what strains will be placed on our treasuries. However, one thing does seem clear about the prospects for New Brunswick and the other Atlantic Provinces over the years ahead. Traditional regional economic development programs are not likely to strengthen our economies and reduce our unemployment rates. When federal and provincial governments are offering lucrative incentives for industry to locate in Central Canada, it is hard to see how similar incentives can pull industry to the Atlantic region. Maybe successful new strategies will be developed, but I am not optimistic at this point.

The disappointing outlook for regional development efforts makes it crucial that the new fiscal arrangements are fair and equitable and that over the next five years our governments can offer a reasonable level of service without being strangled by taxes or crushed by debt.

I have spoken many times in this forum about the inadequacies of the current equalization program and have waited, patiently for the most part, to get down to brass tacks about changing the present formula.

My case, that something is wrong, is based on the objectives of equalization as outlined in the Constitution. It says equalization is to enable provinces to "provide reasonably comparable levels of public services at reasonably comparable levels of taxation". The current program does not generate enough funds for poorer provinces to do that.

The Government of New Brunswick has one of the lowest levels of spending in the country. Our spending on services is only about 80 percent of the Canadian average. In some basic service areas we are not keeping up with the norms for the rest of Canada. In many new service areas we simply do not offer programs that have been put in place by most provinces in recent years. I refer to such programs as kindergartens, senior citizens income supplements and dentacare for children. If it were not for the fact that our public servants are paid significantly less than the Canadian average, our service levels would be even further from the national norms.

On the tax side, we have raised taxes since 1982-83 significantly more than all provinces as a group. I know from where I sit that New Brunswick has an onerous tax burden. While I have the scars to prove it, this is a very difficult case to substantiate statistically. According to data in the equalization formula our taxes are lower than the Canadian average. They are even lower than Ontario if you believe the equalization formula.

This is a very important point because the whole equalization system is designed to make up for a province's inability to generate sufficient tax revenue. If the formula overestimates a province's ability to raise revenue from its tax base, it underestimates the amount of equalization a province needs.

I want you to bear with me a minute while I try to make my point by comparing the major taxes in New Brunswick with the major taxes in Ontario.

Our personal income tax is 8 percentage points higher than Ontario; our sales tax is 4 percentage points higher; our gasoline tax was 1.5 cents per litre higher than Ontario until this summer when falling prices brought our tax down; our tax per cigarette is nearly 50 percent higher; our sales tax and fuel tax bases are as broadly defined as Ontario's; a house in Don Mills bears virtually the same rate of property tax as a similar house in Saint John, New Brunswick. In my judgment, owners of other types of property in New Brunswick pay a higher rate than their counterparts in Ontario. However, on the other side of the coin, New Brunswick does not have a hospital insurance premium. If we had such a tax modelled on the one in Ontario, the revenue so generated would be enough for us to lower our sales tax rate from 11 percent to 9.5 percent. Even with an Ontario type hospital insurance premium, most of our tax rates would still be higher than in Ontario; in some areas a lot higher.

Nevertheless the equalization formula has us at a lower level of taxation than Ontario.

Back home I would not dare cite statistics which purported to show that our taxes were lower than the average. This is one time I know my instincts are right and the technical measure is wrong.

There is no doubt in my mind that this formula seriously overestimates our ability to raise tax revenue and as a result underestimates the amount of equalization we should have.

On previous occasions I have referred to the equalization formula's measure of our ability to raise property tax revenue as one area where it was seriously in error. I am very encouraged by the fact that your staff has looked at this aspect of the formula. Their research proved what common sense tells all of us: land is worth more in big cities than in small towns and rural areas. This research concludes that estimates of land value used in the formula should be increased according to the degree of urbanization of each province. I believe a further change to the urbanization factor was recently made in recognition of particular features of Montreal.

Since data was not available to prove the case for commercial land, federal researchers propose to apply the urbanization factor only to residential land. I would not be so cautious. I would be prepared to trade any 5 acres of commercial land in New Brunswick for my choice of 1 commercial acre in Ontario.

I understand that the changes in the property tax base along with a number of others will increase equalization payments by about $130 million or an increase of about 2 1/2 percent.

The distribution of the additional funds is roughly as follows: the Atlantic Provinces 51 percent; Quebec 40 percent and Manitoba 9 percent. I cannot really judge whether that is a fair allocation of the additional funds. I do know, however, that even with this change, the formula would still overstate New Brunswick's ability to raise tax revenue. However, these changes move the formula a bit closer to reality and the new data shows that New Brunswick's taxes are somewhat higher than Ontario's.

In other words if the changes that have been researched were adopted, the fairness of the formula would be improved, but not by a lot.

All of us around this table have our own fiscal and financial problems to deal with. It is not easy for me in this time of federal restraint to say any enrichment in equalization is not enough. But this is the message I have to leave today.

In an earlier era I could have been optimistic about regional economic development and trust that new industry would be the solution to our fiscal bind. But with regional development programs becoming oriented toward established industrial areas of the country, I do not see how these efforts will do much for us.

New Brunswick has been arguing for a fairer equalization program for several years. However, we did not put off dealing with our financial difficulties because the federal government would not change the equalization formula until 1987. The Government of New Brunswick acted responsibly, on its own, to deal with the deficit and debt left by the recession. After several years of stiff expenditure restraint and increasing taxes, our deficit situation was greatly improved by 1986-87.

The problem now is to keep from slipping backward. We are a part of Canada and demands for a Canadian level of public services cannot be denied indefinitely. On the other hand there is no room on the tax side.

We must have a fair and soundly based equalization program.

Mr. Chairman, I understand the enormous task that you face in dealing with our national situation. I can even understand the reasoning behind your approach to EPF. But I believe the poorer provinces are sailing much closer to the wind fiscally than you realize. I speak not as a technician analyzing data, but as a politician who has dealt first hand with the problem. The fiscal system of New Brunswick and the other Atlantic Provinces is severely strained.

I cannot speak for the other Atlantic Provinces, but I would suggest that an additional $250 million in equalization for the region would avert major fiscal problems. That is an increase in the cost of the program of only 4 percent.

I would encourage you to consider this as a target in your final decisions on equalization.

As a first step I believe you should adopt the research proposals put forward by your staff. They have done a lot of good work and I compliment you for the support you have given their effort.

The improvements to equalization flowing from this research could be extended at little cost to the federal treasury. This could be achieved by making the urbanization factor used to estimate the value of residential land also apply in estimating the value of commercial land. Such a change is logical and justifiable since textbooks on urban economics reveal that commercial industrial land in urban centres is more valuable than residential.

According to our estimates such a change would only add $58 million to federal costs and be distributed fairly evenly among Manitoba, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland. Quebec would lose about $3 million, leaving that province with a net gain from all changes of about $50 million.

I hope my remarks do not come across as simply a pitch for more money. That may be a consequence, but it is really a plea for a bit more equity in a system that shows signs of going the other way. Thank you.

STATEMENT BY

HONOURABLE JOHN B. M. BAXTER, Q.C.

MINISTER OF FINANCE

PROVINCE OF NEW BRUNSWICK

OCTOBER 1986

STATEMENT BY
HONOURABLE JOHN B. M. BAXTER, Q.C.
MINISTER OF FINANCE
PROVINCE OF NEW BRUNSWICK
FOR THE OCTOBER 31, 1986 FINANCE MINISTERS' CONFERENCE

Mr. Chairman:

I have said on other occasions that there are few issues as important to New Brunswick, or the Atlantic region for that matter, as the equalization program which you recommend to your colleagues for the next five years. I cannot speak for other recipient provinces, but I want to make it very clear that New Brunswick is putting a lot of faith and a good deal of its future in your hands.

On numerous occasions in this forum and others, I have spoken of the inadequacy of the present equalization program. Indeed, I first raised the possibility that something was amiss with the formula with your predecessor, Mr. Lalonde.

When you became Finance Minister, you will recall that I spoke to you of my concern, and I said something was wrong with the formula; that it did not generate enough funds for the poorer provinces.

We have studied the equalization program over the past three years, and as a result of our work I know I am right: there is something wrong with the current formula. How can the formula be right when it says some of the most valuable land in Canada is in the Maritime Provinces. In over-estimating our land value, the formula deprives us of equalization to which we are entitled.

There is no doubt in my mind that the current formula has been unfair to my Province and the Atlantic region for a number of years. This has been confirmed by the review of tax bases by your officials. If technical changes now recommended by officials had been in place in 1985-86, New Brunswick would have received nearly $40 million in additional equalization. During the difficult years since 1982 the inadequacies of the formula undoubtedly contributed to New Brunswick's fiscal problems.

However, I am very encouraged by the fact that your officials have now carried out a sensitive examination of the formula and have some realization that the inequities must be corrected for the next five year period.

I want to make it very clear that New Brunswick strongly endorses the work that has been undertaken thus far by your department. It is my understanding that there is a consensus amongst most provincial officials that your department's proposals represent a genuine improvement to the equalization program.

Having said that, I will repeat what I said in Montreal. Technical improvements to the way the formula measures a province's ability to raise property tax revenue do not go far enough.

Everyone agrees that urbanization affects the value of land. This fundamental principle of urban economics is recognized in the proposed technical improvements by attaching an urban scale factor to the measure of residential land value. However, there is no

similar adjustment for urban scale with respect to commerical-industrial land. Any textbook on urban economics tells you that urban scale is more important for commercial-industrial land than it is for residential. However, I am prepared to accept the same urban scale factor for commercial-industrial land as for residential.

This change would increase the payout of the formula by about $60 million, spread fairly evenly among the Atlantic Provinces and Manitoba. Quebec would lose $2 or $3 million, which is a drop in the bucket of their total entitlement of about $2.8 billion. Even with my proposed modification, in 1987-88 Quebec would receive 46 percent of the additional funding arising from these technical improvements. Quebec would get more than all the rest.

As you know, I have been waiting for three years to have the shortcomings in the equalization formula put right. I said at one of these meetings, that I was prepared to live with whatever came out of a fair review of the tax bases, and that if I were wrong about the unfairness of the property tax base, I was prepared to accept that.

Your officials have now done their work, and with respect to the property tax they have agreed that there is something wrong with this tax base, and it should be put right. They have adopted the principle that urbanization affects land value, but there is a reluctance to build that principle into the formula with regard to commercial-industrial land.

I cannot accept that. I have lived with the present formula for four years, knowing it was flawed. You surely can't expect me to accept a new formula that is obviously flawed from the outset and which could be corrected at so little cost to the federal treasury.

I very much want to leave here with an agreement on a package of improvements to the equalization formula. It is our responsibility as Finance Ministers to do so. As much as I want an agreement in this matter, I can't accept changes which leave an obvious, inequitable, flaw in the formula.

I hope you can be persuaded to agree to my suggestion.

I would say that New Brunswick is as keen to seek enrichment of the equalization formula as any province because our citizens suffer higher unemployment, receive poorer services and enjoy lower incomes than in most other parts of Canada.

But we also appreciate the overwhelming need to reduce the national deficit and to put Canada's financial affairs in order. That is why we are not pressing for a major enrichment but for a more equitable distribution of the equalization pie and for the rectification of obvious statistical anomalies in certain components of the formula.

Mr. Chairman, the entire Atlantic region needs more help and you know it.

STATEMENT BY

HONOURABLE JOHN B. M. BAXTER, Q.C.

MINISTER OF FINANCE

PROVINCE OF NEW BRUNSWICK

DECEMBER 1986

Mr. Chairman, those of us who are struggling to improve our jurisdiction's financial situation know from first hand experience that a moderately expanding economy does not spell the end to restraint. An economy growing at 2 or 3 percent after inflation does not produce sufficient revenue to reduce deficits.

Given the deficits and debt that piled up during the recession a great deal of political will is required to turn the financial situation around, even with an expanding economy.

Despite the reality that dictates continued restraint, I detect a renewed public expectation that government can now expand services in a big way. In part such a growth in expectations reflects the upbeat economic news of the past few years. The particularly strong economy of Central Canada and the improved government services that such an economy made possible also generates higher expectations, even in the slow growth regions.

The harsh reality for most Finance Ministers is that the expenditure squeeze is going to be on for some time, but it is infinitely more difficult when people anticipate that the purse strings can be relaxed. I would add that in New Brunswick's case, success in getting the deficit down has contributed to the view that restraint is now over. I must emphasize it is <u>not</u> - I repeat <u>NOT</u> over and, clearly, as New Brunswick faces an "absolute" that 1987 will be an election year, sustaining restraint will test the integrity and credibility of people in public life.

For some of us, equalization is our major revenue source, and what happens to this program can make or break efforts to improve our financial situation. I am also mindful of the enormous stress in "essential programs" such as health care which in every province is bursting at the seams.

The proposed technical changes are very important in this regard. In our situation another $40 million on top of the current estimate of equalization would be a real boost toward achieving our goal of borrowing only for capital purposes. The additional $17 million arising from my proposal to extend the urbanization factor to commercial property would be a fair and reasonable technical adjustment and significantly assist me in achieving a laudable goal.

On the other side of the coin fiscal arrangements could have quite a different result. It all depends on the accuracy of your projections, Mr. Chairman.

In the normal course of events the difference between the first estimate of equalization and the final number can easily be $30 or $40 million, which is roughly equivalent to one-half our corporate income tax. Such estimating errors are a fact of life which I accept.

However, in addition to these "usual" errors, there is the issue of our population estimate which arises after every Census. It is quite feasible that the Census results will show that New Brunswick's population has been over-estimated for the past couple of years and that we will have to make re-payments to the federal government according to current legislation.

In previous discussions I have concentrated on trying to persuade you on the merits of adopting our additional technical change to the property tax base. At the last meeting you agreed to look at the problem with a view to implementing an appropriate change some time before the books close on equalization for 1987-88.

I would be prepared to endorse your proposals to improve the formula, including the offer to do something over the next year or so about commercial property, if I had a reasonable degree of confidence that our equalization revenue will be as predicted. But that is not possible with this Census thing hanging over my head. We too have to budget.

If you could assure me that the Census factor will not undermine the effect of the improvements to the formula which we have been discussing, I would be happy with the package of technical changes and your commitment to act on my commercial property proposal.

In responding to this I ask you to consider the following points: First, if it turns out that some of the smaller provinces owe the federal government large sums of money, such provinces will be in an untenable fiscal position and there will be a great pressure on you for an ad hoc solution. It is better to make a decision on principle now before the numbers are known.

Second, the new Census figures in addition to the usual adjustments to equalization, make the year following the Census one of fiscal Russian roulette for poorer provinces. I do not believe this is necessary to the fair operation of the program.

I hope you will give favorable consideration to this proposal. It will certainly ease my mind that in 1987-88 I won't have to contend with both growing public expectations and a collapse in our major revenue source. I am apprehensive that a large reduction in equalization would be such a setback that the public support and political will to maintain our fiscal plan would be lost.

Mr. Chairman, our governments are collectively responsible for the financial health of Canada. I trust you are concerned that I succeed in my mission, just as I am concerned that you succeed in your much larger one. Your support means a great deal to New Brunswick's success.